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MONETARY REFORM IN EX-COMMUNIST COUNTRIES

Vaclav Klaus Creating a Stable Monetary Order

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INTRODUCTION

Monetary Reform in Ex-Communist Countries

James A. Dorn

> Our practical choice is very simple. Either we will be able to create the legal, economic, and financial environment in which private investment will create a young and dynamic economy, or we will have long-term stagnation with a low level of foreign investment, increasing unemployment, social pressure, and the danger of the Weimar syndrome. This is a very serious choice, the outcome of which will be very important for the future of Russia and the whole world.
>
> —Yegor Gaidar[1]

Money in Transition: From Plan to Market

Under central planning and state ownership, money was used as a device to control economic life rather than as a medium of exchange. The state monobank closely monitored the flows of money, goods, and resources to ensure correspondence with planned output targets. In essence, the centrally planned economies of the Soviet Union and Eastern Europe were barter economies in which administrative orders, not market-determined money prices, decided the scope and direction of economic activity. Money was passive; money votes played no active role in guiding resources to satisfy consumers' preferences.[2]

Without private ownership and market prices, including competitive interest rates to determine capital values, all economic decisions,

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[1]Gaidar (1993, p. 5).

[2]For a discussion of the passive nature of money under central planning, see McKinnon (1991, pp. 108–10).

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including investment decisions, were necessarily political decisions. The Communist Party's monopoly of power allowed it to determine the criteria for success and failure of state enterprises—and few enterprises were allowed to fail. The absence of bankruptcy, along with an open credit spigot from the state bank for state-owned enterprises, resulted in what Janos Kornai (1986) called a "soft budget constraint" as an inherent feature of socialism.

In sum, the legacy of a centrally planned system of money, credit, and banking is an environment in which (1) money plays no active role in the economy; (2) state-owned enterprises expect automatic access to credit; and (3) banking is noncompetitive, with a dominant monobank acting as the fiscal and monetary agent of the state, monitoring the implementation of planned output targets, and making all the key decisions regarding the allocation of credit. The lack of financial markets means there is no monetary policy as it exists in the West. Statistics on money and credit are well-guarded secrets, and politics, not economics, drives the system of money, banking, and credit.[3]

If ex-communist countries (ECCs) are to make the transition from plan to market, they must overcome the legacy of the centrally planned system of money, credit, and banking that they inherited from former regimes. A dynamic market system depends on sound money and competitive financial markets in which capital is allocated by the forces of demand and supply, as reflected in market interest rates, not by the sluggish hand of state bureaucracy.

The development of markets and a stable monetary order requires both a legal-constitutional transformation and a psychological transformation. Under the old regime, in which the ruling elite dictated political and economic life, there was little respect for the law. People learned to survive by breaking the law and engaging in black-market activities. But if a new regime of private property and free markets is to evolve, individuals must adopt and learn to respect a rule of law that limits the power of government and safeguards individual rights. Constitutional reform is, therefore, an essential component of economic reform.

The adoption of a new constitution, however, will depend on general agreement on a set of principles to be applied across space and time. In addition to accepting the principles of private ownership

[3]For a detailed discussion, see Garvy (1966, chap. 1). According to Garvy (p. 24), under socialism, "the banking system acts merely as a vehicle for the execution of broader government decisions as embodied in the detailed plans; monetary action is not geared to the market but is determined by administrative processes centered on the planned allocation of resources. The familiar tools of monetary policy available to Western central banks are irrelevant."

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and freedom of contract, the ECCs must place high priority on the principle of sound money, and that principle must be grounded in an institutional framework that provides for limiting the quantity of money so as to maintain its value. Monetary reform is thus a crucial element in the transition from plan to market.

Monetary instability can undermine the process of privatization and market liberalization. If the state confiscates the money holdings of its citizens or invalidates the purchasing power of money through inflation, those actions increase uncertainty and undermine confidence in any pledge of the government to protect property rights in the future. When the government reneges on its promise to provide a stable-valued currency, respect for law and order declines. That is why Russian reformer Yegor Gaidar (1993, p. 4) has called "the battle against inflation" a top priority in the struggle to create a market order and a civil society.

The question is, How does one move from a system in which central planning has collapsed to a system of private free markets and a sound currency? To answer that question, one must decide on the nature of monetary institutions for the transition period, as well as consider the principles and strategy for achieving long-run monetary stability. The problem is how to make the transition to a stable monetary order and then to maintain that order so that nascent market economies will be able to flourish.

The papers in this issue of the *Cato Journal* address the question of monetary reform in ECCs, both during the transition period and from the perspective of the long-run search for stable money.[4] At the center of that search is the issue of how to depoliticize money and produce a monetary regime that is characterized by credibility, confidence, and choice.

A Stable Monetary Order

The collapse of communism in the Soviet Union and in Eastern and Central Europe opened the door for radical political and economic reform. Entrenched interests have slowed reform, but as the political situation stabilizes and democratic governments emerge from the ashes of socialism, the challenge will be to limit the economic power of government by protecting private property rights and freedom of contract. If elected officials protect inefficient enterprises from

[4]The papers and comments in this issue of the *Cato Journal* were first presented at the Cato Institute's Tenth Annual Monetary Conference, "Money in Transition: From Plan to Market," which was held March 5–6, 1992, in Washington, D.C. The conference was supported, in part, by grants from the Earhart Foundation and the Soros Foundation–Hungary.

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competition, build a new welfare state on top of the decayed system of central planning, and use the central bank to provide the needed funds, then economic stagnation and monetary chaos will follow.

The only sure way to create political and economic stability in ECCs is to return to a rule of law that protects persons and property and to cultivate monetary institutions that are committed to sound money, so that people have confidence in the future value of money. The problem is how to foster competition so that the state's monopoly power over currency and banking is not absolute.

The solution to monetary instability in ECCs is not to block choice in currencies and in banking but to encourage choice by allowing the use of foreign currencies and by allowing Western banks to compete with their counterparts in the East. The path will then be open for institutional innovation as entrepreneurs learn from their successes and failures.

Credibility, Confidence, and Competition

Instead of seeking aid from international agencies to form a stabilization fund, the ECCs should be thinking of how they can implement and maintain a monetary constitution that severs the link between the fiscal affairs of government and monetary affairs. As long as there is no limit on the monetary powers of government, the state will continue to abuse its privilege of printing money.

Accountability is critical to the search for stable money. If ECCs decide to stay with the status quo of central banking, they will have to set clear rules for monetary policy and determine how to hold monetary authorities accountable for deviations from the long-run goal of price stability.

No matter what set of monetary rules is ultimately chosen in ECCs, the rules will have to be credible if people are to have confidence in them. To maintain a discretionary monetary regime, in which monetary authorities are not bound by any clear principles, would be to go "back to the future." The arbitrariness of decisionmaking and uncertainty about the rules of the game that characterized the old regime should not be perpetuated in a new economic and monetary order.

The new market-liberal order should be built on social and political consensus. Such consensus, argues Vaclav Klaus (1993, p. 527), is "a basic precondition for creating a stable monetary order" and "goes beyond technicalities." In his opinion, "There is no technical, organizational, or institutional device that could potentially make up for the lack of political responsibility, for the lack of political and social consensus, in a country that wants to have a stable monetary order."

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People should be free to choose the institutions and the rules they live under. But it may take time for new rules to emerge, that is, for consensus to occur. In the meantime, every effort should be made to avoid excessive increases in the quantity of money and credit, which would fuel inflation and discourage foreign investment.

The case for a monetary constitution is that it would raise the level of credibility so that people would have confidence in the value of money. "It is not enough that prices are stable," writes Antonio Martino (1993, p. 535), "they must also be expected to remain stable." In his view, "The monetary constitution must not be designed for the transition, must not be intended to last only for a limited time, but it must explicitly aim at guaranteeing price stability for an indefinite duration."

Competitive capital markets are essential for a vibrant market system that channels private savings into productive investments and promotes economic growth. Sound financial institutions and a system of competitive private banks widen investment opportunities and consumer choice. But a sound financial and banking network depends, at base, on a strong currency that is readily convertible into both domestic goods and foreign currencies.

The lack of internal and external convertibility of the ruble, for example, has hampered the development of financial markets and discouraged trade and investment in the former Soviet Union. Oleg Bogomolov (1992, p. 368) notes, "The absence of a true monetary system that provides genuine purchasing power that is freely convertible into goods and, later on, into foreign currencies calls into question the entire economic reform." Without stable money and the freedom to trade currencies, the freedom to trade goods will be less valuable.

Monetary competition is important in the transition from plan to market because it provides individuals with the opportunity to shift to a parallel currency if the local currency is unstable. Monetary competition would exert pressure on the domestic central bank to get its house in order. The difficulty is that politicians normally oppose such competition, because they would no longer be able to raise revenue by printing money.

Allowing competition among currencies and among monetary institutions, as proposed by F. A. Hayek (1976, 1978a), would encourage innovation and the emergence of sound money. Institutional choice is an important component of individual freedom, and that freedom will lead to what Douglass North (1992, p. 479) calls "adaptively efficient rules"—that is, rules that "provide

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incentives for the acquisition of knowledge and learning, induce innovation, and encourage risk taking and creative activity."

The problem with the Soviet-type economic system was that it could not adapt to change. Individuals were told what to do, rather than allowed to experiment and fail so that errors would not accumulate. In dealing with the problem of transition, therefore, one should keep in mind the need for adaptively efficient rules.[5] And provision should be made for such rules in the monetary regime as well as in other areas of economic, social, and political life. Competition could then work to improve monetary institutions and bring about economic, social, and political order.

The question that transitional economies face is, What can be done to promote credibility, confidence, and competition in the short run while constructing a long-run stable monetary order? William Niskanen (1993, p. 729) writes: "Leaders in ex-communist countries do not have the luxury of an extended academic debate on the issues that bear on the choice among alternative monetary institutions. They must get on with their job under conditions that most of us would regard as chaotic."

As a starting point, ECCs, especially those experiencing or facing hyperinflation (notably Russia and Ukraine) can learn several important lessons from Germany's post–World War I monetary reform.

Lessons from the German Stabilization

Germany's experience with hyperinflation and stabilization in the aftermath of World War I shows: (1) credibility is essential if new policy initiatives are to be successfully implemented and maintained; (2) confidence in the currency depends on a stable-value currency, and such value is best maintained by limiting the quantity of money; (3) competition between the depreciating official currency and a sound parallel currency will speed stabilization; and (4) the money supply must be divorced from the budget—the central bank must not be allowed to monetize government debt as a source of revenue.

Monetary stabilization achieved credibility because Germany's leaders preceded monetary reform with budgetary reform; took responsibility for monetary reform away from the Reichsbank, which had engineered the hyperinflation; and made it clear that the new rules of the game would be enforced. As a result, when the government instituted monetary reform in November 1923,

[5]According to North (1993, p. 21), "The objective of restructuring must be the creation of an adaptively efficient economy—that is, one that over time will provide an institutional framework for a wide menu of alternative choices for organizational innovation and also wipe out failures."

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people believed there would be an end to hyperinflation, and that expectation helped minimize the costs of the transition to stable prices without serious, long-lasting effects on employment and output.[6]

The rapid depreciation of the paper mark in the autumn of 1923 led the German government to issue a decree on October 15 that (1) established the Rentenbank; (2) authorized it to issue a parallel currency, the rentenmark, which entered into circulation November 16; and (3) strictly limited the quantity of rentenmarks the new bank could issue. The government promised to redeem rentenmarks for government-backed mortgage securities: for every 500 rentenmarks, an individual could obtain a bond with a nominal value of 500 prewar gold marks. Thus, each rentenmark acquired a value of one gold mark.[7]

Constantino Bresciani-Turroni (1937, p. 348) attributed confidence in the new currency to the fact that the Rentenbank refused to exceed the upper limit placed on the issuance of rentenmarks, even though the government pressured the bank to do so in December 1923. The credible quantity constraint, argued Bresciani-Turroni, gave the rentenmark—which, in fact, was an inconvertible paper currency—a stable value and was "of primary and fundamental importance."

Before the introduction of the rentenmark, there was a "spontaneous reaction of the economic organism against the depreciation of the legal currency" (Bresciani-Turroni 1937, p. 345). As many as 2,000 "emergency monies" had been introduced—some legal, some illegal—in the search for a stable currency to substitute for the rapidly depreciating paper mark. But many of the parallel currencies were unsound, and Germany was in a state of "monetary chaos" (p. 343).

In that climate, the rentenmark, which was a "legal means of payment" but not legal tender, entered into circulation alongside foreign currencies, emergency monies, and paper marks. The new currency tended to drive out the emergency monies and to decrease the velocity of circulation of paper marks. The result was that even though the money supply continued to increase, the rate of inflation began to stabilize. By November 20, 1923, the rate of exchange

[6]For a discussion of these points, see Humphrey (1980, pp. 5–6). He argues that the German experience teaches us that "the task of subduing inflation is easier if the policymakers have established a record of credibility, if they accurately convey their intentions to the public, and if they convince the public of their resolve to stop inflation" (p. 6).

[7]See Bresciani-Turroni (1937, pp. 334–35, 337, 340, 348n).

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between the rentenmark and the paper mark settled at one rentenmark for one trillion paper marks.[8]

A further reason for the stabilization was that when the rentenmark first entered into circulation, on November 16, 1923, the government prohibited the Reichsbank from monetizing government debt, thus ending the government's ability to finance its deficits by printing money. The Reichsbank, however, continued to extend commercial credit (Bresciani-Turroni 1937, p. 337).[9]

In October 1924, a new currency, the reichsmark, was introduced to replace the paper mark, and the rentenmark gradually disappeared from circulation. The new legal tender was defined in terms of gold, but convertibility was suspended until April 1930 and then allowed only at the discretion of the Reichsbank (Bresciani-Turroni 1937, pp. 353–54).

The key lesson to be learned from the German monetary reform is that credibility, confidence, and competition are essential ingredients for a successful transition from monetary chaos to monetary order. Monetary stability is most likely to be achieved if there are limits on the quantity of currency and if people are free to choose the soundest currency, so that good money drives out bad or depreciated currency.[10] The challenge for ECCs is to discover the monetary institutions that will best enable them to achieve stable money so that market prices can coordinate economic activity in an efficient manner.

Options for Monetary Reform in ECCs

The papers in this volume consider various options for monetary reform during the transition period and reflect on the principles that should guide the evolution of monetary institutions over time. The options include the use of Eurocurrencies and Western banking services to facilitate international transactions, the adoption of a currency board to issue a parallel currency that would be tied to the dollar or another "hard" currency, the evolution of free banking as a means of providing competition in the issuance of currency to prevent the currency board from acquiring monopoly power, and the use of a

[8]See Bresciani-Turroni (1937, pp. 334–35, 337, 348).

[9]The Reichsbank did not begin to restrict commercial credits until April 1924, because of the danger of creating a severe business depression. The bank's concern over inflationary pressures, however, convinced it to control money growth (Bresciani-Turroni 1937, pp. 351–52).

[10]See Hayek (1976, pp. 18–19, 39–44). According to Bresciani-Turroni (1937, p. 401), "The German example is particularly instructive because it shows that, if the monetary authority . . . does not put some limit to the issues of paper money, prices continue to rise until astronomical figures are reached."

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commodity reserve to anchor the value of money (such as a gold-backed ruble) and prevent inflation.

Of course, another option would be to create an independent central bank and limit the quantity of money by a constitutional constraint on money growth or by adopting a nominal GNP target consistent with long-run price stability. Vaclav Klaus (1993, pp. 527–28) prefers "a two-tiered banking system and the independence of the central bank"; and he favors "rules—but rules understood as clear, transparent concepts, not as rigid technical prescriptions." For him, price stability should be the overriding objective of monetary policy.

In principle, all ECCs want to abolish the state monobanks, create a system of private commercial banks, and divorce the central banks from the fiscal arm of government. The problem is figuring out how to depoliticize money and banking. Countries, such as the Czech Republic, that have an institutional memory of Western banking institutions and stable money will find it easier to return to a two-tiered banking system and an independent central bank than will countries, such as Russia, that are confronted with hyperinflation and lack even the remnants of independence and discipline in the conduct of monetary policy. For the latter countries, the immediate need for monetary stability may be better met by looking to options other than the status quo of central banking.

Central banking is neither necessary nor sufficient for stable money and a private, free-market system. What is necessary is a credible commitment to sound money, and that can be achieved by adhering to the "quantity principle" or to the "convertibility principle"—the former would limit the quantity of money or money growth to stabilize the long-run price level, while the latter would provide a spontaneous adjustment of the quantity of money to the demand for money to achieve roughly stable prices over time.[11]

Unfortunately, the history of central banking gives little reason to believe that central banks can provide stable money by adhering to the quantity principle. As Wayne Angell (1993, p. 678) points out:

> History offers a depressing number of examples where discretionary monetary policy has led to disaster. Even in the best of circumstances, fiscal pressures, political considerations in general, as well as genuine uncertainty about what exactly is the best route to take to price stability, conspire to undermine the pursuit of sound money under a managed fiat currency system.

Thus, convertibility and competition appear to offer a more credible institutional framework for insulating money from politics and achieving

[11]For a discussion of the "quantity principle" and the "convertibility principle," see Axel Leijonhufvud (1984, pp. 99–100).

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stable money than does central banking, especially in ECCs that have little credibility to begin with.

To break loose from the old state monobanking system, ECCs need a privately run commercial banking system with competitive capital markets, not a governmentally run central banking system that issues fiat money and is not subject to an effective quantity rule.[12] Fortunately, until such a system can be formed, there is a ready-made substitute—namely, the Eurocurrency market and the complementary Western banking institutions.

Adopting Eurocurrencies and Western Banking Practices

A. James Meigs (1993) argues that the most practical way for ECCs to create a stable monetary order during the transition is to allow the use of Eurocurrencies for international transactions and allow Western commercial banks to operate freely in ECCs. The Eurodollar, for example, could be used as a medium of exchange and unit of account for moving goods and capital among the newly formed countries of the former Soviet Union and the newly independent countries of Eastern and Central Europe.

The use of the Eurodollar and other Eurocurrencies would help promote trade relations among the former members of the Council for Mutual Economic Assistance (COMECON) and avoid the call for autarky that normally follows on the heels of domestic monetary uncertainty. The idea is to provide for a parallel currency that would circulate alongside rubles and other ECC currencies and allow the free movement of goods and capital.

Meigs's advice is for governments "to get out of the way and allow entrepreneurs . . . to make their own arrangements" in the Eurocurrency market (p. 725). Moreover, he argues that while latching onto the Eurocurrency market and Western financial expertise, ECCs should remove exchange controls, liberalize trade, permit their currencies to be fully convertible, adopt a floating exchange-rate regime, privatize state enterprises, embark on budgetary reform, and move toward domestic monetary stability.

Instituting a Currency Board

In 1918 and 1919, a currency board, the "Emission Caisse," existed in North Russia. The North Russian caisse issued a fully convertible ruble that circulated alongside the numerous fiat-issued paper rubles in North Russia. Convertibility was maintained, and the new ruble

[12]Paul Volcker (1991, p. 125), former chairman of the Federal Reserve, has written: "I don't think a central bank is essential to a market system historically. What is really essential . . . is a commercial banking system."

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issued by the caisse tended to drive the depreciated fiat monies out of the market.[13] Steve Hanke and Kurt Schuler (1993b) think that experiment can be repeated in the new Russian Federation—a parallel currency would eventually put the Russian central bank out of business.[14]

Writing in the *Financial Times*, Hanke and Schuler (1993a) expressed their lack of faith in the ability of the Russian central bank to stabilize the ruble: "As long as Russia has a central bank it is likely to have an inconvertible currency highly prone to inflation. The only way to stabilise the rouble permanently is to change Russia's monetary institutions."[15]

Under the Hanke-Schuler proposal, the Russian currency board would be an autonomous body that would issue a new currency fully backed by a hard currency (probably the dollar) or a commodity basket. If the dollar were the chosen reserve currency, the fate of the new ruble would be in the hands of U.S. monetary authorities rather than in the hands of Russian central bankers. The supply of new rubles would be determined by market forces, and convertibility would ensure that the value of the ruble would be fixed in terms of the dollar. The new ruble would be allowed to float against the old ruble, with the expectation that good money would once again drive bad money out of circulation.

Making the Transition to Free Banking

The currency board can be viewed as a transitional monetary institution, or as a "bridge between central banking and free banking" (Hanke and Schuler 1993b, p. 701). Once the board creates a sound currency, private banks would begin to evolve and to issue their own bank notes, provided there were no legal restrictions. If consumers chose to hold the privately issued bank notes, the currency board would itself go out of business.[16] So while credibility and confidence are essential elements of a stable money regime, the survival of such a regime is best ensured by allowing competition in the supply of currency—or so argues Pedro Schwartz (1993).

According to Schwartz, currency boards should not be given a monopoly on note issue; they should be private, competitive organizations. His strategy for Russia would be "to set up a nonmonopolistic

[13]For a discussion of the North Russian currency board, see Hanke and Schuler (1991, pp. 658–63).

[14]For a detailed discussion of the currency board option for Russia, see Hanke, Jonung, and Schuler (1993).

[15]The same argument is made in Hanke and Walters (1993).

[16]See Hanke and Schuler (1993b, pp. 700–701) and Dowd (1993).

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currency board, which could slowly ease itself into the system by the spread of spontaneous acceptance, without the government even noticing what is happening" (Schwartz 1993, p. 625). The new currency "would be a parallel, freely competing currency" and "have no connection whatever with the government and its budget deficit" (p. 630). In time, the currency board might wish to anchor its currency to gold or another commodity rather than to the dollar, which itself has no firm anchor. The private, convertible currency would not be legal tender but would float against the official currency and other privately issued currencies. The free market would determine which currencies survived.[17]

In 1991, Annelise Anderson wrote: "The Soviet Union has done no better at providing people with sound money than it has providing them with food and other consumer goods. Here as elsewhere, a turn to the market would be the best choice." In her present paper, Anderson (1993) explores in detail the case for a "competitive solution" to Russian hyperinflation. Her conclusion is that institutions matter and that competition among monetary institutions is the surest way to produce sound money and banking.

Restoring a Gold-Backed Ruble

During the reign of Peter the Great, a gold coin, the "chervonets" (or "chervonetz") circulated in Russia. The chervonets symbolized sound money, and, in November 1922, V. I. Lenin drew on that symbol to try to stabilize the Soviet ruble, the "sovznak," which was rapidly depreciating. Lenin introduced a parallel currency, which he called the chervonets, and authorized the partial backing of the new currency by precious metals. The chervonets gained credibility and served as a viable substitute for the government-issued fiat money. Gold chervonets coins appeared in 1923 and circulated along with the chervonets notes. In February 1924, the Russian government began circulating another currency, the gold treasury note, which had no fixed relation to gold but was limited in supply. Those reforms helped restore monetary order during Lenin's New Economic Policy.[18]

Restoring a gold-backed ruble as a parallel currency may offer a way to anchor the ruble and help Russia make the transition from plan to market. What Russia needs, writes Oleg Bogomolov (1993, p. 596), is "to create some anchor to stabilize the monetary system and the emerging market economy. A currency parallel to the ruble

[17]See Schwartz (1993, pp. 630–31).

[18]See Hanke, Jonung, and Schuler (1993, pp. 150–55). They write (p. 155): "The chervonets had only moderate credibility, but it was a much more stable and credible currency than the sovznak. It contributed greatly to the revival of the Soviet economy during the period of the New Economic Policy."

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(chervonets) with solid commodity backing . . . and freely convertible into foreign currencies might serve as such an anchor."

Alan Reynolds (1993) proposes a real gold standard for Russia. He would make the ruble fully convertible into gold and provide for the circulation of gold coins and gold certificates. Along with free coinage, he would permit free banking. He believes such a system would make the ruble "as good as gold" (p. 675).

Wayne Angell (1993, p. 679) agrees that "it is vitally important that Russia have a sound money right from the start of its transition to a free-market economy." However, instead of the genuine gold standard proposed by Reynolds, Angell favors some flexibility and argues for adopting a "gold price target," which he refers to as an "error-tolerant monetary plan." Under his scheme, the money supply would be allowed to expand if the price of gold fell below the target price, but "the target could be missed if there were a danger of a severe contraction of economic activity" (p. 680). The Russian central bank would not be required to sell gold if the price of gold rose above the target price. Angell recognizes that the introduction of discretion into the monetary regime entails the risk of losing credibility, but he thinks such a scheme is a plausible means of achieving price stability.

The Experimental Method

The free coinage of gold could be combined with free banking to generate a competitive system of money and banking. However, Angell (1993, p. 679) sees such a development as "visionary." In his view, if the economies of Western democracies are not "sophisticated enough in their use of markets and in their acceptance and understanding of competitive forces to rely on free banking and competing currencies," then one should not expect Russia to experiment with "untested economic theory"—especially in light of the failed socialist experiment. Vaclav Klaus (1993, p. 527) is also "not interested in any new social experiments"; he opts to stay with "standard institutional arrangements" for money and banking.

The fact that socialism failed should not prevent experimentation with free-market alternatives to the status quo of central banking and the state's monopoly over the supply of currency. The whole idea of a market-liberal order is to experiment with new institutional rules and to let individuals choose the economic, social, and political arrangements that best protect private property rights and generate wealth. The problem with socialism, as practiced by the Soviet Union and its satellites, was that there was no room for freedom of choice.

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All the experiments were conducted by the Communist Party—not for the people, but for the protection of the ruling elite's control over political and economic life.

It takes time to build new monetary institutions, and competition among alternative monetary rules is an important part of the learning process. Free competition should not be confused with socialist experimenting. Consent characterizes the free market, while coercion characterizes central planning. The market's "experimental method" is a discovery process that results in mutual gain;[19] a plan's social engineering is a command process that results in gains to the planners but not necessarily to the people. The search for adaptively efficient rules does not take place under socialism. We should not prevent that search from taking place under capitalism by outlawing free banking and competing currencies.

According to Pedro Schwartz (1993, p. 630), the use of "a freely competing currency board" should be seen "as using the experimental method," rather than "as experimenting" in the socialist sense. Allowing a private parallel currency to compete with the government currency would be one way to test the superiority of a market-based monetary order over a centrally planned monetary order.

Insulating Money from Politics

The search for a stable monetary order, which protects the value of money and encourages a market-liberal order, is a search for a monetary constitution or a set of rules that insulates money from political manipulation, so that the rules are credible and people have confidence in the long-run value of money. The depoliticization of economic life in ECCs must include the depoliticization of money and banking. Competition via the experimental method can help achieve that result and bring about sound money in the process.

In considering options for monetary reform during the transition from plan to market, as well as in considering the monetary framework for the longer run, ECCs should heed Hayek's (1976, p. 16) advice:

> Our only hope for a stable money is indeed now to find a way to protect money from politics. . . . What is so dangerous and ought to

[19]Pedro Schwartz (1993, p. 630) uses the term "experimental method" to distinguish the trial-and-error process of market-based reform measures from planned reform measures that allow no room for choice among alternative institutions. Schwartz's conception of market experimentation is consistent with Hayek's notion of market competition as a method for discovering new information (see Hayek 1978b, chap. 12, "Competition as a Discovery Procedure").

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> be done away with is not governments' right to issue money but the *exclusive* right to do so and their power to force people to use it and to accept it at a particular price.

That advice leads one to question the status quo of discretionary central banking and the security of government fiat money.

Klaus's adherence to monetarism is a step toward a nondiscretionary monetary regime with clearly enforced rules to limit money growth, but he fails to take the next step toward the depoliticization of money and banking. The introduction of a parallel currency, issued by a freely competing currency board, would create a competitive monetary regime and pave the way for free banking and privately issued bank notes, which could be backed by gold or a commodity bundle. Those options, including as a first step Meigs's use of Eurocurrencies to help spur international transactions, offer a challenge to the status quo and should help stimulate debate about the future course of monetary institutions in both the East and the West.

The challenge is to remove the obstacles to new monetary arrangements and to let the market process operate so that ECCs can discover adaptively efficient rules. To meet that challenge will require an intellectual revolution in which individuals come to recognize that monetary order, like market order, is best achieved by cultivation rather than centralization—by limiting government rather than extending government.

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Creating a Stable Monetary Order

Vaclav Klaus

A Precondition for Monetary Order

A stable monetary order is for me both a goal and an instrument for achieving other goals. My crucial message is the following: a basic precondition for creating a stable monetary order goes beyond technicalities. This is something I would like to stress very much. In my understanding, there is no technical, organizational, or institutional device that could potentially make up for the lack of political responsibility, for the lack of political and social consensus, in a country that wants to have a stable monetary order. Political and social consensus is for me a crucial precondition, and I spend most of my time trying to maintain and establish exactly that precondition in my own country.

It seems to me wrong to suggest alternative institutional arrangements, such as currency boards, to compensate for the lack of political responsibility or to compensate for the incapability of politicians to establish and maintain basic support for rational economic policy. I have to advocate standard institutional arrangements, even if they may not be intellectually challenging. We are not interested in any new social experiments. We enjoyed 40 years of living in a traumatic social experiment; it was more than enough. Therefore, we are very conservative.

The Conduct of Monetary Policy

Standard institutional arrangements mean, for me, the creation of a two-tiered banking system and the independence of the central

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The author is Prime Minister of the Czech Republic. The paper is based on his luncheon address at the Cato Institute's Tenth Annual Monetary Conference, March 5, 1992, at which time he was Finance Minister of Czechoslovakia.

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bank. What are the policy prescriptions we have to follow? In principle, I favor rules—but rules understood as clear, transparent concepts, not as rigid technical prescriptions. Rational monetary policy needs clearly defined goals and priorities, and there is no more important goal than price stability.

I view monetarism as an inspiration, not as dogma about technical details. My problem, and not only mine, is the question of how to conduct monetary policy in a situation of extreme fluctuations in economic performance during economic transition. This is a crucial question. All the well-known textbook prescriptions are extremely useful as a basic orientation, but one has to add something to that. At the end of the 1990s, all of us will have perfect time series to analyze our mistakes, but we do not have such time series now, and we have to act. We have to conduct monetary policy with all the uncertainties we face. There is no simple advice, but I have two suggestions.

First, in the early stages of the transformation process, we must conduct a very restrictive monetary policy. Second, the traumatic decline in production observed during the transition is not a standard depression. Thus, there is no expansionary policy that can cure that decline or prevent unemployment from arising. It is more proper to say that the existing output decline is the result of the transformation shakeout, that is, the shakeout of irrational economic activities. The faster such economic activities die, the better.

Very often I have to face arguments in my own country—and, I am very sorry to say, in the West as well—that there is a depression or crisis in Czechoslovakia, Hungary, and Poland, and that this crisis requires expansionary economic policies. That is a very dangerous misinterpretation. I have made no optimistic assumptions about the elasticity of the aggregate supply curve of an economy under transition, and I am pretty sure that expansionary policy would bring inflation and nothing else. The question is when to make a policy switch to a less-restrictive monetary policy. It is quite clear in a country like Czechoslovakia that it must be done after price deregulation. (Today 95 percent of all prices are free to move, which is more than in most Western European countries 10 years ago and probably more than in some Western European countries even today.) A switch to a less-restrictive monetary policy must occur after price deregulation, trade deregulation, and privatization of an important segment of the economy. But this policy is still no real answer.

To my great regret we do not live in an easy world of homogeneity. We live in a heterogeneous world. We live in a mixed world with a growing private sector, which reacts to market signals, and a shrinking, but still huge, state-owned sector that does not react to market

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signals. The state-owned firms are in a state of preprivatization agony. One of your businessmen recently made a very good analogy. He said that state-owned firms in Czechoslovakia behave like they are in a freezer. They are frozen, they do not smell, they do not move, they do not react. We live in such a complicated world, and to discover the proper moment to make monetary policy less restrictive is for me a task we have to solve now.

There are some additional analytical issues in the field of monetary policy that are my current headaches. Our basic analytical frame of reference is the quantity theory of money with its equation of exchange, MV = PT. We think in terms of the famous four variables and implicitly use them to analyze our economic situation, our economic policy.

The Unreliability of Official Data

The problem of the unreliability of data on prices and output is well known. During the old system, economic data favored the communist regime. During the transition to a market economy, however, the official statistical data help to discredit the reform efforts. Because there are many unreported economic activities in the mushrooming private sector, statistical offices are unable to analyze and take into consideration all the economic data. In my country, the official data really fail to show the fluctuations in output due to the privatization of small-scale businesses. For example, our statistical office publishes retail trade data only for firms with more than 100 employees. In November 1991, retail trade for those firms had declined by some 35 percent. While such information would be extremely relevant for any standard and stable economy, and especially for a centrally planned economy where all retail firms have more than 100 employees, it is now absolutely irrelevant. Nevertheless, the decline in that measure of retail trade made the headlines in Czechoslovakia and in the *New York Times* as well. The unreliability of data on prices and quantities is, therefore, a crucial issue.

Is Monetary Policy Overly Restrictive?

But this is not the main problem we face. I am afraid that our monetary policy may be too restrictive. My hypothesis is that in a country moving from a centrally planned economy to a market economy, transactions grow much faster than current output. So if monetary policy focuses on increasing the money supply in line with current output, monetary policy will be overly restrictive. For that reason I have some doubts about our monetary policy.

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Why is it that transactions grow faster than output? There may be at least three reasons. The first is that in the past we have had only current output transactions, whereas, in the transformation period, we have huge property transfers. The differences between current output transactions and property transactions are large in a newly emerging market economy. As such, a simple quantity of money equation, which relies on current output, will underestimate the demand for money. This is a serious concern.

Second, in the world of central planning we had only real transactions, payments for the delivery of goods and services. There was no financial sector. However, in the transition to a market system, financial transactions become important and add to the demand for money.

Finally, there is another important reason for a dramatic increase in transactions in economies making the transition to a market system, namely, the enormous multiplication of the number of economic agents as markets widen. In the past, economic transactions were very often done administratively inside large enterprises without the intermediation of money. But today there are many new economic agents and numerous exchanges among thousands of firms instead of movements of goods inside large firms. This institutional change is another reason for the enormous increase in the demand for money and why it is so difficult to measure the demand for money in such a situation.

Monetary policy may also be overly restrictive because of the conservative nature of our commercial banks. At present, we have two different patterns of commercial-bank behavior in Central Europe. We have the behavior of commercial banks in countries like Poland and in the former Soviet Union, where the situation is such that commercial banks grant credits very easily. And we have the behavior of commercial banks in Czechoslovakia, where the newly born independent banks try to play a very conservative role and are probably overcautious. (They have their new general directors with their cigars à la Paul Volcker, and when a newly born entrepreneur comes to ask for a loan, the bank directors tell them, "You don't look sufficiently promising.") The difference probably reflects the different mentalities in various countries of Eastern and Central Europe. We were always overcautious in the past in Czechoslovakia, and the overly conservative behavior of our commercial banks creates an additional problem that we have to solve. There is no reason to try to force the banks to grant more credits, but we are afraid that maybe they are too risk-averse.

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Other Issues in Creating a Monetary Order

There are three final issues, which I will just mention. First, there is the issue of whether one country should try to enter the global economy alone or whether it should try to organize a regional monetary arrangement as a way to integrate itself with the global economy. My answer is straightforward. There is no reason to create sophisticated, complicated, and artificial monetary arrangements. To create, as I like to call them, "poor man's clubs" is a safe way to block our fast entry into the world economy.

The second issue is whether we should keep restricting currency convertibility to current account convertibility or whether we should jump immediately into the world of capital account convertibility. I have nothing against full convertibility, but for practical reasons it seems that current account convertibility is sufficient for us now. It is sufficient because it opens the country to the rest of the world. We do not intend to centrally plan the introduction of competition at home. For us the best way to liquidate domestic monopolies is to introduce international competition, and this is exactly what current account convertibility accomplishes.

The third issue is whether to have fixed or flexible exchange rates. I was horrified at the very beginning with the idea of having fixed exchange rates. I remember at the same time that the IMF was shocked when I suggested a flexible exchange-rate regime. I was really afraid that announcing a fixed, highly devalued exchange rate three days before the introduction of price liberalization could create a vicious inflationary spiral. I wanted to let the exchange rate be free to move for sometime and maybe only then introduce a fixed exchange rate. I am glad that I was wrong in this respect. Nothing happened with the preannounced fixed exchange rate, and it seems to me that to use the exchange rate as an anchor for all other monetary variables in the economy is a good policy.

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A Monetary Constitution for Ex-Communist Countries

Antonio Martino

> The importance of monetary stability derives from the significant independent influence of monetary change on the subsequent course of economic activity. If money did not matter at all or were of only secondary importance in affecting the flow of spending, income, and prices, monetary stability would be of little relevance.
>
> —Michael D. Bordo and Anna J. Schwartz[1]

The Case for a Monetary Constitution

After the interlude of the Keynesian revolution, monetary stability has been restored to its status as an important policy goal (Dorn 1987). The experience of the 1970s and 1980s and the theoretical works that have accompanied it have helped dispose of most Keynesian ideas on money and monetary policy. From the point of view of its importance, price stability has reacquired the position it held in pre-Keynesian times, when it was believed that a stable purchasing power of money was a necessary precondition for a free and prosperous economy.

In a Keynesian world, price stability is not necessarily desirable. Most Key- nesians were convinced that inflation was the unavoidable price of economic growth, that there was a stable trade-off between inflation and unemployment, that it was possible to reduce interest rates through monetary expansion, and that the time horizon for monetary policy decisions had to be dictated by the needs of short-term stabilization policies. All of these views have succumbed to

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[1]Bordo and Schwartz (1983, p. 63).

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the empirical evidence and the theoretical analyses of the last 20 years.

There is no evidence that economic growth inevitably involves price inflation. On the contrary, there are good reasons to believe that monetary instability hinders long-term projects and makes economic growth more difficult, as evidenced by the experience of a number of Latin American countries.

The idea of a stable trade-off between inflation and unemployment is thoroughly discredited: an unexpected acceleration of inflation may temporarily reduce unemployment below its "natural rate," but this effect is short-lived. Only an accelerating inflation could keep unemployment below its "natural rate," but even that unappetizing possibility is dubious (Friedman 1968, 1975, 1977; Bordo and Schwartz 1983).

Manipulation of monetary aggregates can influence interest rates only temporarily: as soon as inflationary expectations catch up with reality, the Keynesian "liquidity effect" is replaced by the "Fisher effect," which will more than offset the initial impact of the unexpected change in monetary policy (Thornton 1988). Nominal interest rates tend to be higher, not lower, when monetary policy is loose.

As for stabilization policies, it is now largely (though certainly not unanimously) agreed that our insufficient knowledge, unreliable short-run macroeconomic forecasts, and variable time lags in the impact of monetary policy decisions make it likely that policies aimed at stabilizing the short run may end up being pro-cyclical rather than counter-cyclical. Attempts at fine-tuning the economy often result in additional, avoidable instability (Friedman 1951, 1953, 1962, 1969; Haberler 1974; Meltzer 1991).[2]

For these reasons, the old pre-Keynesian wisdom that monetary stability is a necessary (though by no means sufficient) condition for economic progress has again acquired widespread popularity. Price stability may not be a cure-all, but, while there is no long-lasting benefit to be gained from the instability of the price level, this may in itself be the cause of serious economic problems.

In other words, the post-Keynesian "counter-revolution" has resulted in the abandonment of money as an instrument of (discretionary) policy, limiting its role to its three traditional functions as unit of account, medium of exchange, and store of value or "temporary abode of purchasing power," to use Milton Friedman's felicitous expression.

[2]"Monetarists . . . favor stable policy rules that reduce variability and uncertainty for private decision-makers. They argue that government serves the economy best by enhancing stability and acting predictably, not by trying to engineer carefully timed changes in policy actions which are frequently destabilizing" (Meltzer 1991, p. 31).

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I mention these well-known facts because if monetary stability were not desirable, if discretionary (and erratic) monetary policy were advantageous, the whole subject of a monetary constitution would lose its meaning. It can be argued that monetary stability is even more important for a country in transition from central planning to the market. In such a country, the amount of long-term investment projects is unusually large: infrastructures need to be built, obsolete plants and equipment need to be replaced by economically viable ones, and the remains of the follies of planning must be removed to make room for the new structures (Jordan 1991, Hanke and Schuler 1991). Building a market economy from scratch requires confidence in the future and long-term investment plans; both need a stable money. All the more so since the reconstruction will inevitably need the participation of foreign investors, who are certainly not encouraged by countries with dismal records of monetary performance.

The lesson for policymakers in ex-communist countries (ECCs) is simple enough: money must be regarded as an integral part of the institutional framework—monetary stability being one of the rules of the game—and not as an instrument of policy. The transition involves transferring from the arbitrary decisions of authorities to the market the most fundamental task of any economic system: that of directing resources to their most productive uses. However, for the price system to perform that task satisfactorily, prices must not send wrong signals; that is, inflationary "static" must not interfere with the working of prices. That is why price stability, always a precious commodity, is of paramount importance for the transition process of ECCs.

Finally, it is not enough for prices to be stable; their stability must also be regarded as long lasting, not as a transient and accidental phenomenon. When people plan for the distant future, the expected behavior of prices matters more than past behavior (Leijonhufvud 1987). The argument for price stability, in other words, must be complemented with the case for the *credibility* of a policy of stability. It is not enough that prices are stable; they must also be expected to remain stable. It is here that the need for a monetary constitution comes in. The monetary constitution must not be designed for the transition, must not be intended to last only for a limited time, but it must explicitly aim at guaranteeing price stability for an indefinite duration. There is no need, in other words, for special monetary arrangements aimed at easing the transition process and destined to be replaced by other rules once the transition is completed. The commitment to monetary stability must be intended and interpreted

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to be a permanent one, so as to encourage long-term projects and earn the confidence of domestic and foreign investors.

That a monetary arrangement guaranteeing price stability for the indefinite future should be the ultimate aim of reformers in ECCs can be more easily agreed upon than what the transitional path to stability should be. It has been argued that a disinflationary policy adopted before the privatization of the economy has been completed could have serious drawbacks and be doomed to fail. If a monetary squeeze replaces present inflationary tendencies, the effect on the reallocation of resources may not be as successful as it would be in a market economy. In a country where resources are privately owned and markets are allowed to operate, the slowdown induced by a monetary squeeze is likely to be temporary and its effects to be compensated by efficiency gains as resources are more rationally allocated. In a still collectivized economy, it can be argued that such a reallocation of resources is unlikely to take place, so that the monetary squeeze will affect "most the smaller and more privatized entities . . . rather than the politically protected large state owned enterprises" (Walters 1991, p. 41). Rather than moving resources toward more productive uses, the disinflation would hurt the small productive units and discourage new initiatives. Furthermore, as Alan Walters notes, "the squeeze devastates the SOEs [state owned enterprises] profits and since much of central government revenue is derived from the surpluses, there is a catastrophic fall in government revenue, which . . . will induce monetary expansion to fill the gaps . . . which in turn generates a new wave of inflation."

Such an analysis is probably too catastrophic. Taken literally, it would appear to suggest that an inflationary monetary policy, by inflating the SOEs' profits and hence the government revenue, would be a precondition for a reduction in the government deficit and a slower rate of monetary expansion. In order to bring the inflation down, one must first conduct an inflationary policy! Aside from this paradox, the fact remains that if the economy is not privatized there is no transition. As long as there is no market, the problem is that of defining the ideal monetary policy for a command economy. Furthermore, even assuming that the pessimistic evaluation is justified, what is the alternative? The continuation of the old inflationary policy would not make the transition simpler, it would solve no problem, and it would add difficulties of its own making to an already tragic situation. This is why in what follows I shall assume that we are talking about countries that are really moving from plan to market, where privatization is being achieved on a large scale, new markets are continuously coming into existence, and prices are freed from

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administrative control. If, on the other hand, aside from market-talk, nothing is being done in the real economy to allow the price system to work, markets to be formed, and private property to be securely established, monetary arrangements become secondary: there are no monetary gimmicks that can make a semi-paralyzed, near-command economy prosperous and successful.

I shall not, therefore, make any distinction between monetary arrangements for the initial stages of the transition and those for the final steps. My point is that discretionary monetary policy is seldom useful and often harmful, and this is true in a market economy, in an economy in transition from plan to market, and even in a planned economy. What we have learned in the past 20 years is that manipulating monetary aggregates on a daily or weekly basis will solve no problem and it might add to the overall instability of the economy. From an a priori point of view, the ideal rate of inflation may not be zero, but nobody has suggested a better number yet.[3]

What Kind of Monetary Constitution?

The argument in favor of a monetary constitution in general and for ECCs in particular leaves us with the problem of choosing the specific set of rules to be adopted.[4] Now, it is indeed more important to agree on the need for rigid rules that to agree on the particular rule to adopt (see Buchanan 1983, p. 144). However, as long as supporters of monetary constitutions widely disagree on what kind of rules must replace the present discretionary conduct of monetary policy, they are unlikely to make theirs a convincing case. I shall, therefore, look at some of the monetary constitutions that have been tried or proposed and attempt to single out their advantages and drawbacks, in the effort of finding an arrangement suitable for ECCs.

Gold

The oldest form of monetary constitution is the gold standard, which can still count on many advocates. Supporters of gold believe that a gold-backed currency would severely limit the discretion of

[3]"Proposals for monetary reform usually assume that the public prefers a noninflationary rate of monetary growth. This may be true, but it has not been demosntrated. Nor has it been shown that the rate of inflation that maximizes wealth, or the utility of wealth and private consumption, is identically zero" (Meltzer 1983, 1987 p. 204).

[4]"Unless we can get an effective change in monetary regimes, we cannot expect our politicians or our central bankers to resolve the incipient stagflation dilemma. Until and unless we begin to take the long-term perspective in our private and in our public capacities, including the adoption of new and binding constitutional constraints on the fiscal and monetary powers of government, we are doomed to remain mired in the muck of modern politics" (Buchanan 1983, pp. 145–46). Also, see Simons (1936).

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monetary authorities and the power of government to debauch the currency for political purposes. On the other hand, critics of the gold standard maintain that historically its performance was not as good as its supporters claim.[5]

The trouble with gold, as emphasized by Milton Friedman (1961), is that there is an enormous difference between a 100 percent gold standard—a "real" gold standard in which gold is used as money—and a "pseudo" gold standard, in which money is linked to gold through government fixing of its price.

According to Friedman (1987, p. 373), only a real gold standard "would constitute an improvement rather than a deterioration in our monetary arrangements." Furthermore, if a 100 percent gold standard is destined to evolve into a fractional reserve system (Meiselman 1983), then it is fair to conclude that the monetary arrangement that would result from adopting the gold anchor would be exposed to the kind of monetary instability that has been typical of fractional reserve systems, with bank panics and the like (Cagan 1987).

However, the historical evidence on the performance of gold is mixed and far from conclusive. For example, Italian history from 1845 to 1915 seems to support the case for gold. The gold standard was the ruling monetary system from the beginning of "Risorgimento"—the process by which Italy became unified and the pre-unitarian states were dissolved—until World War I erupted. Those were years of great transformations, comparable in scope, even though not in direction, to what is going on in the ECCs. It may be more than a historical curiosity to see how this early type of monetary constitution performed.

From 1845 to 1915, the nominal price of gold was not perfectly stable, but it fluctuated year in and year out, periods of stability being followed by sharp decreases or increases (see Figure 1). Moreover, the *real* price of gold fluctuated along a declining trend until the unification was completed (1871), and it continued to swing along a fairly stable trend until the start of World War I (see Figure 2). During those 70 years, consumer prices were not stable: the unification was accompanied by inflation, followed by deflation, then stability, and finally moderate inflation in the first decade and a half of the 20th century (see Figure 3).

However, if one looks at the gold standard years in a historical perspective, there is no question that in terms of price stability those were years of unrivaled success (Figure 4). If the yardstick by which one measures the success of a monetary standard is price-level

[5]For a vigorous debate on the pros and cons of a return to gold, see Meltzer and Reynolds (1982).

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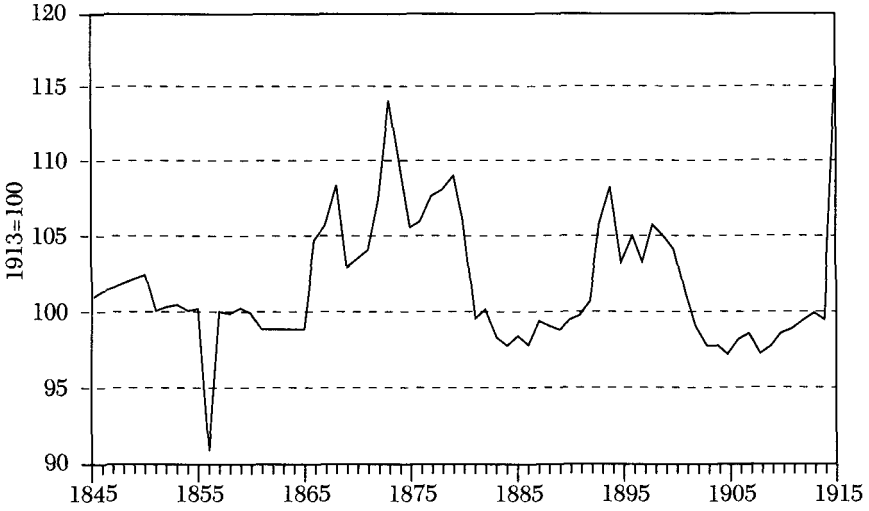
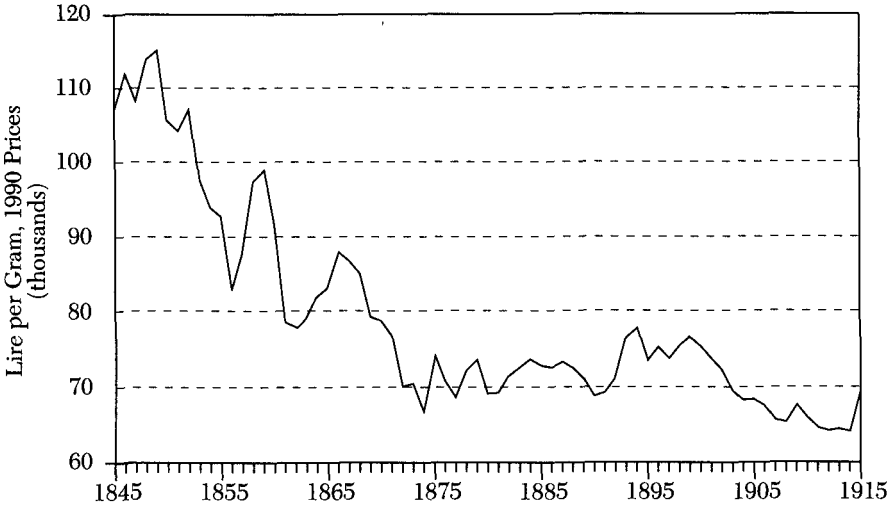
FIGURE 1
ITALY: THE PRICE OF GOLD, 1845–1915



Source: Banca d'Italia.

FIGURE 2
ITALY: REAL PRICE OF GOLD, 1845–1915



Source: Banca d'Italia.

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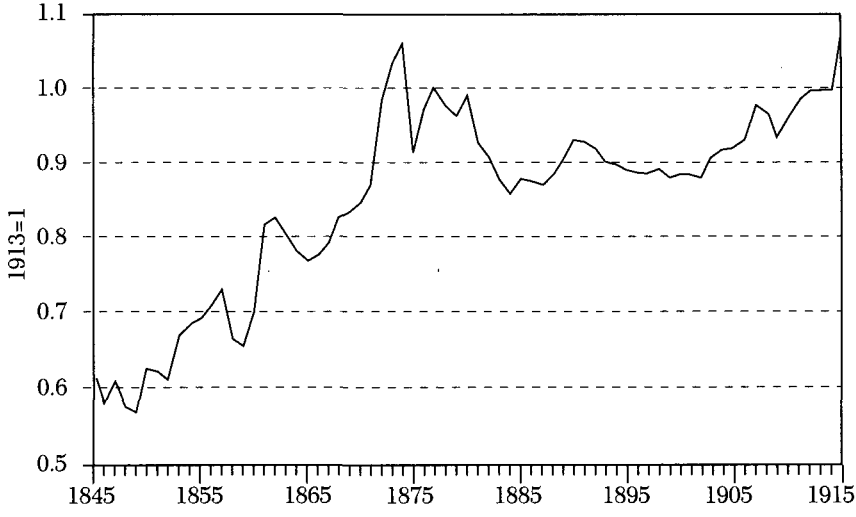
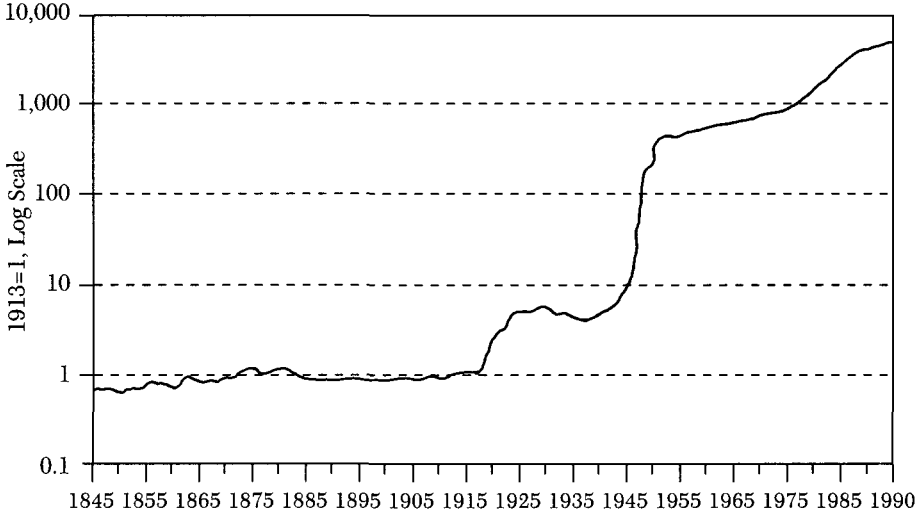
FIGURE 3
ITALY: CONSUMER PRICE INDEX, 1845–1915



Source: ISTAT, Banca d'Italia.

FIGURE 4
ITALY: CONSUMER PRICE INDEX, 1845–1990



Source: ISTAT, Banca d'Italia.

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stability, the gold standard period, on the basis of this circumstantial evidence, was superior to any other time in Italy's history.[6] One can question whether this outcome is entirely attributable to the gold anchor or not, but it is a fact that those were the most stable in the past 145 years of Italian history.

The obvious answer to the apparent contradiction in the evaluation of the performance of gold is that it is better to have some kind of monetary constitution limiting the discretionary powers of monetary authorities, no matter how imperfect, than to have no constitution at all. The gold standard was far from perfect, and it is doubtful whether it could provide us with an answer to today's problems, but it has proven, at least in the case of Italy, to be better than a purely discretionary regime.[7]

Currency Competition

Following a famous proposal by Friedrich A. Hayek (1976), a more radical kind of monetary reform has received considerable attention: the privatization of money. Different monetary instruments would be offered by competitive suppliers, and, if the rates at which they would be exchanged for one another were flexible and continuously determined by the market, a virtual circle would be established by a Gresham's law in reverse, which would lead to the elimination of the less-stable currencies in favor of the more-stable ones.

It is beyond the scope of this paper to go into the details of the various proposals.[8] I shall limit myself to looking at competing currencies as a monetary constitution that could be adopted by ECCs. Let me make it clear that I am convinced that choice in currency is an important component of freedom in general and a desirable feature of a truly free society (Friedman 1991). However, I believe that there are various reasons, aside from political feasibility, that make private competitive currencies unsuited as a monetary constitution for ECCs.

The first, and possibly most important, function of money is to be a unit of account, allowing prices to be expressed in a single measuring unit. The simplification money introduces in economic

[6]For a comprehensive analysis of Italy's monetary history, see Spinelli and Fratianni (1991).

[7]Almost all academic economists are convinced that the gold standard does not provide an answer to today's problems. Gottfried Haberler (1974, p. 162), for example, states: "The gold standard broke down with the outbreak of war in 1914. It was superficially restored in the early 1920s but was definitively swept away and abandoned in the Great Depression. There is now no chance that it will be resurrected."

[8]For an excellent presentation of the argument for competing currencies, see Vaubel (1986).

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calculations is enormous.[9] Money prices transmit information (Friedman 1984) and allow markets to perform their function of information retrieval systems (Hayek 1945). As such, money resembles language: it conveys information. As in the case of language—most people are proficient in only one language—we tend to think in terms of one unit of account (Cagan 1986). Whenever we are abroad, in a country using a different currency, we experience, at least at the beginning, a marked difficulty in understanding the meaning of prices expressed in the foreign currency. It would be costly to think in terms of two or more currencies all the time, especially if—as required by the logic of competition—their exchange rate would vary continuously.[10] People are much better off with one yardstick, one unit of measurement—in fact that is the very reason why they have a unit of measurement in the first place. Converting all the time from meters and centimeters to feet and inches gets to be annoying, useless, and time consuming. In all likelihood, therefore, most people would prefer thinking in terms of only one currency, and competition between currencies would be severely limited. On a priori grounds, this objection would seem to carry particular weight in countries where people have very limited experience with the working of prices and markets.

Second, according to the logic of competing currencies, competition favors the most stable one, thereby creating an incentive for the money suppliers to make sure their currency is not rejected because of its instability. Yet, stability does not seem to be the only criterion for success in currency competition: the U.S. dollar is not the most stable currency in the world, yet most international transactions are conducted in dollars. Other factors play a role in the competition of currencies. One of the most important factors is the size of the domestic market. Like language, whose usefulness increases with the number of people speaking it, the importance of a given currency increases with the number of people using it. Its acceptability tends to be self-reinforcing: the greater the number of people who already use it, the more likely it is that it will become acceptable to others, largely without regard to its past performance. The Swiss franc may be more stable than the U.S. dollar, but the fact that the number of

[9]Instead of having n prices for n commodities, without money the number of prices would be $T = 0.5\, n(n\text{-}1)$. In a world of 1,000 commodities, instead of 1,000 money prices there would be 499,500 "real" prices (Mundell 1968, pp. 45–46).

[10]"If the money issued by different banks competed freely in the market, the result would be either the emergence of a private monopoly or oligopoly of money creation, or the circulation, side by side, of several kinds of money with fluctuating exchange rates between them. Either one of these outcomes would be intolerable. The immediate result would be to bring the government back into the business of money creation" (Haberler 1987, p. 80).

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people using the Swiss franc is smaller makes people prefer to use the dollar. In short, currency competition is likely to be imperfect and unlikely to act as a filter mechanism in favor of the most stable currency.

Finally, as in the case of language, in the choice and use of money there is a considerable amount of inertia (Bordo and Schwartz 1983): people do not ask themselves which is the most effective language for communicating with others, they just pick up the language spoken in the area where they grow up. And, once they have learned it, they continue to use it. This is because in most cases the cost of learning another language outweighs the benefits. Thus, people normally stick to the language they already know. The same is true of money: the dollar may be a monetary instrument superior to the Italian lira, but when I am in the United States I always translate prices from dollars into lire to understand their *real* meaning. Currency competition is more a notion for theoretical economists than a realistic proposal for monetary reform, especially in countries where monetary sophistication is limited.

A Monetary Growth Rule

The third kind of monetary constitution is the well-known one of a constant monetary growth rule (Friedman 1959, 1969).[11] The logic of this proposal is well known and it need not be repeated here. In one form or another, it is accepted by nearly all monetarists.

I am still convinced that Friedman's monetary rule would offer a superior monetary arrangement in most circumstances. However, we must acknowledge the fact that (at least in a legislated form) it has never really been tried and that, in Friedman's (1987, p. 368) own words, even in the United States "the Fed has been unable or unwilling to achieve such a target, even when it sets it itself, and that it has been able to plead inability and thereby avoid accountability." This poses a major problem to supporters of this type of monetary constitution: if even the monetary authorities of the country where the case for Friedman's rule is known best (the United States) have been unable or unwilling to enforce it, what likelihood is there that it might be given a chance in countries where its significance is less understood and appreciated?[12]

[11] I have argued that a monetary growth rule would be the ideal arrangement for Europe should the European Economic Community (EEC) adopt a common currency (Martino 1990).

[12] Friedman (1987, p. 369) has been forced to acknowledge: "I remain persuaded that a monetary rule that leads to a predictable long-run path of a specified monetary aggregate is a highly desirable goal—superior either to discretionary control of the quantity of money by a set of monetary authorities or to a commodity standard. However, I am no longer so optimistic as I once was that it can be effected by either persuading the monetary authorities to follow it or legislating its adoption."

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The unpleasant conclusion of the previous considerations is that, for one reason or another, none of the major types to monetary constitutions that have so far been proposed appears immune to criticism. The gold standard would have the advantage of simplicity and credibility, but in its fractional version it would be exposed to crisis, it would not necessarily guarantee economic stability, and it would not be self-enforcing: monetary authorities might decide to go off gold whenever they deemed it necessary.[13] A monetary constitution based on competing currencies has the enormous advantage of not being dependent on the goodwill of authorities for its existence: it is self-enforcing. However, it is doubtful that it would work, and even more doubtful that it could be an appropriate solution for countries that lack sophisticated knowledge of prices and markets. The monetary growth rule would be ideal if authorities would allow it to work, but the empirical evidence available so far suggests that, even if formally adopted, it would not be carried out. It would seem that monetary economists have no workable rule to prescribe. We agree on the need for a monetary constitution, but we have not devised one that is likely to be appropriate for ECCs, acceptable to its rulers, and likely to deliver monetary stability.[14]

A Modest Proposal

The problems faced by ECCs in their attempt to go from a centrally planned to a market economy are enormous. To a large

[13]In the case of gold there is an additional difficulty. While a gold-backed currency would be ideal in terms of its credibility for countries that are beginning to try to come out of the communist mess, and despite the enormous mining potentialities of the former Soviet Union, gold reserves, according to the latest figures, are not adequate. According to *The Economist* (1992, p. 73), the "former Soviet Union . . . has reserves of only 240 tonnes, a tenth of what most western analysts had long reckoned it had." Therefore, a gold standard must be ruled out, or, as one of its supporters, Robert Mundell, reluctantly concludes: "Gold can no longer be the solution" (1991).

[14]After the first draft of this paper was written, I came across a very interesting proposal by Hanke and Schuler (1991b, 1992). The currency board plan they support is extremely elegant in its simplicity, but it leaves two questions unanswered. First of all, aside from all the well-known objections to fixed exchange rates, how are we to find out which exchange rate between the foreign reserve currency and the domestic currency is "appropriate" (1991b, p.23)? A short period of floating would allow us to single out the rate appropriate for present circumstances, but how do we know whether the same rate would be appropriate in the future, given the tremendous changes that are likely to take place? Second, the "real" money supply now in circulation in ECCs, notably the former Soviet Union, is as small as the authors claim for the obvious reason that those countries are undergoing very rapid inflation. If, accepting the authors' proposal (1991b, p. 25), we move from the present arrangement to the one proposed, freezing the "real" money supply at its present, low level, the inevitable outcome would a dramatic, disastrous deflation and depression.

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extent, they are also unprecedented, so that the literature on how to go from plan to market is virtually nonexistent.[15] Furthermore, each of the former communist countries is different from all others because of its history, culture, and degree of economic performance. The idea of a general prescription for success valid for all countries is, therefore, quixotic at best. And, as for a monetary constitution, it is hard to believe that countries in a state of institutional disarray may succeed where our "free" countries have egregiously failed for so long, despite the determined efforts of monetary economists and public choice theorists. Finally, as I have tried to show, economic theory does not offer a foolproof recipe for monetary stability, one that is definitely going to be accepted by the relevant authorities, sure to be implemented once accepted, and certain to deliver monetary stability if implemented.

Yet, before succumbing to defeatism, it is worth remembering that there are no irreversible historical processes and that there is no reason why ECCs could not succeed where others have failed. In fact, if it is true that they are today in a precarious, if not desperate, economic predicament, it is also true that for them the stakes are higher than they would be for any of our "free" countries. We can endure a moderate amount of instability; in their case monetary instability might frustrate their aspirations of prosperity and their hopes for freedom.

What follows has neither ambition of precision nor claim of originality: most of the reflections that follow are well known, and they are all of questionable validity. But, I feel entitled to take refuge in Harold Adams Innis' observation: "The answer to those who demand answers is that there are no answers" (quoted by Johnson 1975, p. xii).

[15]John G. Greenwood (1990) lists five preconditions (he calls them "fragile foundations") for a successful economy that should be adopted by ECCs: (1) the rule of law, (2) a relatively incorrupt bureaucracy and independent judiciary, (3) predominantly private ownership of property, (4) free market prices, and (5) a stable monetary system. According to Meltzer (1991, p. 276): "To work efficiently, the market requires institutions and structure. Private property, accounting and legal systems, and a monetary framework must be put in place." However, he acknowledges that "Economic theory does not provide a blueprint for the transition from socialism to a market economy." To the above preconditions, Niskanen (1991) adds the "cultural attitudes" that are essential for the proper functioning of a market economy. There is little doubt that all of these are necessary (though it is doubtful that they are sufficient) ingredients for the transition. One moment's reflection on their extraordinary scope and importance will make one wonder if the chances of success in ECCs are as good as we all hope. Nutter's (1969) analysis of the differences in the organization of a communist society as contrasted to a free society gives a vivid illustration of the breadth of the transformation.

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Some Preconditions: Privatization

As previously mentioned, a monetary constitution's main purpose is that of allowing the price system to work effectively in allocating resources and in facilitating long-term investment decisions. It is a device for reducing uncertainty and favoring the risk-taking choices that are essential to economic progress. However, in order for the price system to work, people must respond to the incentives that are implicit in price changes. This poses no problem on the demand side: buyers are likely to economize on items affected by a price increase, and vice versa. But, as long as production is in the hands of "public" entities, it is far from certain that price signals will produce the necessary reaction on the supply side. In other words, for the price system to work, supply must be decentralized and the economy must be privatized. Extensive privatization of the economy is far more important than stability for the success of the transformation. And, it is doubtful that ECCs would be interested in the stability offered by a stagnating economy. As long as the size of government remains overbearing, there is little hope for prosperity and economic growth.

A Fiscal Constitution

The second fundamental precondition for a successful monetary constitution concerns again the size of government: the level of spending, taxation, and the deficit. It is generally recognized that fiscal and monetary rules are strictly connected (Meltzer 1987, 1991; Jordan 1991). This is fairly obvious: monetary instability is often the result of budget deficits, inflation being instrumental to the financing of government spending. Of the two main causes of instability—mistakes in the conduct of monetary policy and "artless budget deficits," as Machlup used to call them—the second has always been prevalent, and it seems the more relevant for ECCs.

Here again the experience of our "free" countries is not particularly encouraging: despite the declared best intentions of governments, spending, taxation, and borrowing have continued to grow unrestrained in many countries. The explanation of the contrast between the good intentions and the appalling results is simple: the growth of government is not a managerial problem; it cannot be solved by changing the managers. It is a problem of rules: without an effective set of constitutional constraints, political

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incentives will always and everywhere result in the uninterrupted growth of spending and taxation (Martino 1989, 1990).[16]

It is absolutely indispensable, therefore, that the monetary constitution be accompanied by a fiscal constitution, limiting government spending and taxation and mandating a balanced budget. On this last issue, I must make clear that I am aware that an annually balanced budget is not necessarily the best prescription from a stabilization point of view. A policy that would balance the budget over the cycle would be superior. However, the experience of several countries suggests that the growth of government spending is facilitated by the possibility of running a deficit. Furthermore, once the limitation of an annually balanced budget is removed, there are powerful incentives that push in the direction of increasing deficits. Such, for example, has been the experience of Italy since 1961 (Martino 1989, 1991).

In some cases, it might be difficult to achieve a balanced budget in a relatively short time. Also, the attempt could be very costly from a political point of view.[17] For example, the consolidated budget deficit of the republics of the new Commonwealth of Independent States (CIS) is estimated to run in excess of 20 percent of GNP (Sachs 1991). It would be nearly impossible to eliminate a deficit of that size overnight. What the fiscal constitution could and should mandate is an obligatory tendency toward a balanced budget: all new or greater expenses should be financed exclusively out of tax revenue or by the reduction of other expenditures (Martino 1982). In any case, debt monetization should be forbidden: the government should be prohibited from borrowing from the central bank.

Federalism and Reverse Revenue Sharing

A budget balanced on an annual basis would be desirable only insofar as it would be implemented at a "low" level of government spending: the Swedish prescription of a nearly balanced budget with spending in excess of 60 percent of GNP is not what I would recommend as a model for ECCs.[18] A mandatory balanced budget combined with a tax limitation provision could be an effective way to achieve a ceiling on government spending (Friedman and Friedman, 1979).

[16]"There will be no escape from the protectionist-mercantilist regime that now threatens to be characteristic of the post-socialist politics in both Western and Eastern countries so long as we allow the ordinary or natural outcomes of majoritarian democratic processes to operate without adequate constitutional constraints" (Buchanan 1989, p. 8).

[17]An interesting historical illustration of the political cost of pursuing a determined policy of balancing the budget is offered by Italy from unification in 1871 to 1876, see Martino (1991).

[18]For an excellent analysis of Sweden's present predicament, see Stein and Dörfer (1991).

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The constitutional solution should also address the problem of the relationship between the various levels of government. Federalism, which is today advocated as the appropriate solution for the peaceful coexistence of different geographic, ethnic, or linguistic groups within the same country, also offers an indication for a constitutional solution to the problem of taxation. What I have in mind is a system of "reverse revenue sharing" as suggested by Dwight Lee (1985). Under such an arrangement, all taxing authority would reside in the local units of government (at the level that best suits the history of the country), and each local unit would be required to give the central government some proportion of the tax revenue it raises, with this proportion being uniform over all local units of government.

The advantages of such an arrangement would be numerous (Lee 1985). First of all, it would establish some kind of fiscal competition among the different local governments, because excessively oppressive local tax systems would drive taxpayers away toward more favorable tax environments. No local unit would therefore abuse its taxing authority, and an automatic constraint on taxation would become effective. Furthermore, if the proportion of tax revenue to be given to the center is, say, 50 percent, for every dollar the local unit spent, it would have to extract two dollars from its citizens in taxes. Obviously, the local units should also be subject to a balanced budget constraint. The combination of a balanced budget at both the central and local level and of the automatic constraint on taxation produced by reverse revenue sharing would result in a powerful disincentive to the growth of total government spending, and one that would need no policing to be enforced.

Apart from the fiscal constitution, the decentralization of government seems to offer the kind of flexible structure needed to accommodate regional diversities within the country. Federalism also allows policy competition and experimentation: the debate on public policy problems can then leave the abstract and dogmatic domain of ideological confrontation and be based on the more pragmatic and potentially fruitful approach of comparing the concrete results of the various policy solutions. Since there is ample room for legitimate disagreement on what the ideal tax structure should be, the experimentation made possible by federalism and fiscal competition could provide the "discovery procedure" needed to arrive at a more meaningful understanding of the problem and of its possible solutions. Federalism could also offer a healthy check on total government power and on its tendency to grow over time: it is no accident that federal structures, like those of Switzerland or the United States, have often been more successful in containing the growth of government

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than nonfederal ones. Finally, the ideals of federalism can be betrayed and corrupted, witness present tendencies in the United States or the growth of euro-dirigisme in the EEC. There clearly is the additional task of devising constitutional constraints on the central powers in federal structures to prevent them from evolving into the kind of centralized Leviathan they were supposed to replace. While reverse revenue sharing would represent a first important step in the right direction, more needs to be done. This last problem, while strictly connected with that of a monetary/fiscal constitution, obviously lies outside the scope of this paper.

A False Problem: the Monetary Overhang

One of the monetary problems of the transition that has received considerable attention is that of the so-called monetary overhang, the idea that citizens of ECCs hold more cash than they really want because there is nothing they can spend it on (Walters 1991, Sachs 1991). The existence of this large amount of unspent cash balances in the hands of the public has led to speculation on how to prevent it from creating an inflationary bubble: should the government mop up these balances with a large issue of bonds, use them as the counterpart in the privatization program, or inflate them away? A conceivable solution could have been offered by monetary reform, a change in the monetary unit, the conversion of the excess supply of the old currency into the new currency at a noninflationary rate. In short, the solution to the monetary overhang should have received high priority in the transition to a stable monetary system.

There are good reasons to believe that the problem will disappear with the liberalization of prices: once goods become available, there is no reason to suppose that people will be holding more cash than they really want. If prices are liberalized, the overhang will wither away. Discussion of a monetary constitution for ECCs can proceed as if the overhang never existed.

Should the Existing Currency Be Replaced by a New One?

An important question is whether the introduction of a monetary constitution should be accompanied by the adoption of a new monetary unit. On the one hand, it could be argued that changing the currency would make it evident that the authorities were seriously committed to a policy of monetary stability. On the other, what has been said before about the inertia in the use of money on the part of most people would suggest the opposite conclusion: a change in the monetary unit might add to the general climate of uncertainty and make matters worse. There is no general answer

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to this question, and in most cases the problem is already solving itself. Those countries where the transition is well under way without hyperinflation will not need to change the currency. But those countries that do not succeed in avoiding hyperinflation—by the time they decide on a new monetary constitution will need introduce a new currency.[19]

The Isolated Country Case

As previously mentioned, ECCs are not homogeneous. The monetary constitution, therefore, will be different depending on the country's characteristics. For a country that has avoided hyperinflation in the initial stages of the transition and wants to retain total independence and national monetary sovereignty, the adoption of a fiscal constitution of the kind outlined above plus a monetary growth rule should take care of most of the problems.[20]

If the country is large enough to afford it, flexible exchange rates should also provide the solution for its international monetary relations (Friedman 1950, 1953). Full convertibility and freedom of foreign exchange markets would also guarantee a modicum of currency competition: if they so choose, people would be allowed to hold foreign exchange (or gold) as a more reliable store of value than nominal assets denominated in the country's currency. Distrust of the stability of the national currency would lead people to take refuge in foreign currencies (and/or gold) and give the authorities a signal of their incipient failure.

[19]Gordon Tullock (1991) has suggested that ECCs "should start with two currencies—the one which they now have, and which is inflating and which should be managed in such a way that it continues inflating at whatever the rate it has right now, and a new one which would be held stable. All existing contracts would be in terms of the currency in which they were made, i.e. the existing currency, and people would be free to make future contracts in either one. I would assume that this system would lead rather quickly to the extinction of the existing currency and the substitution of the new one. No one should get particularly hurt provided the monetary authorities can guarantee both stability for the new currency and that the old currency will inflate at its historic rate."

[20]Two crucial aspects of the monetary growth rule that I have not dealt with here are (1) the precise numerical value of the rate of growth of the money supply, and (2) the choice of the monetary aggregate for targeting. The reason for the omission is fairly obvious: the choice of the monetary aggregate depends on the institutional framework of the country in question. A particular aggregate might be suitable in one country, and totally meaningless in another. No monetary theorist I know has ever claimed that there is only one monetary aggregate meaningful for all countries. In general, the monetary base is now the favorite choice of many monetarists, but even that preference is not absolute. As for the rate of growth, its precise numerical value has always been considered by proponents of a monetary growth rule as less important than the fact that it is maintained for a long period of time with little or no variability. A "*steady* and known rate of increase in the quantity of money is more important than the precise numerical value of the rate of increase" (Friedman 1969, p. 48).

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If, on the other hand, the country is too small to afford a flexible rate regime, it could peg its currency to that of a larger country. However, historical evidence on this arrangement is contradictory: it seems to have worked well in the case of Hong Kong, but it contributed to the Chilean recession in the early 1980s. The moral of the story is that in some circumstances a small open economy cannot afford complete monetary sovereignty and may be forced to give up the use of its own currency.

The Commonwealth of Independent States

The formation of the CIS offers the former Soviet Union a chance to develop an effective confederation, in which the center would supply a few genuine "public goods" (like common foreign defense and control of nuclear armaments) and the independent states would take on the other legitimate functions of government. Assuming that the initiative is successful, it would provide a framework for a monetary constitution different in one respect from the one outlined above for a single isolated country.

The ongoing debate on whether each republic should be allowed to have its own currency or remain within the ruble area—that is, continue to use the Russian currency—could be solved by having the CIS adopt a "dual-currency system." The CIS as such would continue to use the ruble, and each republic would be allowed to have its own currency provided it accepted the rules suggested above for a fiscal constitution and constant monetary growth. This arrangement could play an important role in the enforcement of the individual republics' monetary constitutions.

As previously mentioned, experience suggests that formal acceptance of a monetary growth rule does not automatically guarantee its implementation. This poses the problem of policing the enforcement of the rule. One could think of the introduction of a structure of incentives and disincentives aimed at making sure that monetary authorities do not, intentionally or unintentionally, depart from the target rate of growth of the money supply. The central bankers' salaries could be tied to their performance in implementing the monetary rule, and they could be fired if they fail.[21]

However, these arrangements are elaborate and they can always be circumvented by an implicit agreement between political and monetary authorities. When, let us say, it is in the interest of the government to follow a path of monetary expansion in excess of what the rule dictates, it is not difficult to envision a connivance between the government and the central bank aimed at violating the rule. In other words, ideally there should be an automatic mechanism

[21]Something along these lines has been done in New Zealand.

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guaranteeing the enforcement of the rule. It is here, I believe, that the very valuable idea of competing currencies could be applied to the concept of a monetary constitution.

Under a dual-currency system, the CIS currency would compete with the currencies of the independent states or republics in a fashion similar to that which has been suggested for a parallel European currency (Vaubel 1979). Each republic's currency would be freely convertible into the CIS currency. Whenever inflationary expectations for a single republic's currency would increase, people would convert the national currency into the CIS currency. The CIS would then demand the conversion of its excess holdings of the republic's currency into rubles from the republic's monetary authorities, which would be forced to revert to a less-inflationary policy. A mechanism of competition between currencies would thus be established, and it would act as an automatic mechanism of enforcement of the individual republics' monetary rules. The CIS currency would not only provide an alternative to "national" currencies, it would also act as a check on the inflationary propensities of republican governments. Finally, all national currencies should be freely convertible: foreign exchange markets should be completely private, and anybody should be allowed to buy or sell foreign exchange at market prices. This again would reinforce the filter mechanism outlined above, increasing the range of alternatives to national money holdings and extending the competition among currencies.

Conclusion

The suggestions made above are merely an exercise in intellectual speculation and, as previously mentioned, have neither ambition of precision nor claim of originality. In the field of monetary policy more than in that of theory, we must never forget the idiosyncratic nature of most of our recommendations. Institutional factors are extremely important, and they should be taken into account whenever one engages in the unrewarding game of suggesting policy rules. One thing we know for sure: if ECCs really intend to complete their transition from communist planning to market freedom, they will need a currency that is capable of performing its traditional functions adequately (Hanke and Schuler 1991a). We also know that if we entrust the stability of the currency to the discretionary power of monetary authorities, money could become an autonomous, potent source of instability. Hence, the superiority of rules. Which specific type of rule to adopt is in this respect less important than accepting

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the need for monetary rules. Ultimately, the choice of the constitutional setting can only be made in the light of the peculiarities of the relevant country.

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Money and the Market: What Role for Government?

Kevin Dowd

As communism is at last assigned to its rightful place in the dustbin of history, those who survive it have to come to terms with the task of sorting out the dreadful mess it has left behind. Perhaps the only benefit of having lived through communism is that many of those who have done so have a sound grasp of the dangers of government interference in markets. Such understanding leads naturally to a free-market outlook, and many in the former Soviet empire fully understand that the new order must be a liberal one if they are to have any future worth having. But therein lies an immense problem. We understand that the present situation is a total mess, and we understand that once the transition is made, the new market economy will function smoothly and efficiently, and provide the prosperity and economic security that are so desperately needed. The problem, however, is how to get from here to there, and on that issue we are all to a greater or lesser extent flying by the seats of our pants. We understand reasonably well how healthy free-market economies work, but nursing a chronically sick economy to health is a far more difficult problem that none of us is well equipped to handle, and the problem will not wait until we feel we are ready for it. An immense chasm lies between the present mess here and economic health over there, and we need to think carefully about the transition if the countries of the former Soviet bloc are to avoid falling in it as they attempt to make the leap.

Were we dealing with a particular industry, the bakery industry, say, the solution would be relatively straightforward. We would first

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change the legal framework to allow private bakers to set up and then grow. They would quickly erode the market share of the state bakery corporation, and at some point we would simply abolish the latter and sell off its assets for whatever we could get. There would be some adjustment difficulties, of course, but on the whole the reform should go through without our losing too much sleep about it. Reforming the monetary system and the banking industry is less straightforward, and we need to tread more carefully. We could—and should—reform the legal framework to allow private bankers to set up and compete, but we cannot simply expect them to produce new brands of money in the same way that private bakers would produce new brands of bread, and then abolish the state bank and forget about it.

Money, or to be precise, the unit of account, is different from bread in a fundamental respect that demands that we acknowledge it.[1] There is no reason to believe that the consumption of bread generates externalities, but we cannot say the same about the use of a particular unit of account. A unit of account is a social convention, like a language, and its utility to a user depends to a considerable extent on how many others use it as well. If one more person decides to use a particular unit of account, his decision generates benefits to those who already use it—benefits that have no obvious analog in our earlier bakery example. A unit of account is like a telephone, the utility of which depends on how many others belong to the same unit of account or telephone network. The problem, from our point of view, is that if the utility of a particular unit of account depends on how many others also use it, then an individual's decision whether to stay with an existing unit or switch to using another will depend on what he thinks the others will do, and each individual of course faces the same decision. This element of strategic interdependence explains why it has proved so difficult in the past to induce spontaneous shifts away from badly managed units of account to alternatives with demonstrably superior risk and return characteristics. We might all appreciate that the existing unit of account is performing badly, and

[1]The text should not be misunderstood. It states that the unit of account is different in a particular, albeit important, way because of network economies. It does *not* suggest—and I would vehemently deny—that *currency* is subject to the same network economies as the unit of account. The issue of currency denominated in a particular unit of account is in many respects much like the bakery discussed in the text, and one would expect major benefits from it. It is the provision of the unit of account that is different. Nor should the text be interpreted as implying that the unit of account is different from conventional economic goods in a way that justifies permanent government involvement in its provision. The free banking system described later in the text should make clear that it is not, and the only reason for having any state involvement at all in the interim is to clear up the mess previously caused by the government itself.

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we might each prefer that we all switched over to use some other, but it may not be rational for any of us to switch unless we can be confident that at least a certain number of others will also switch with us.

The optimal strategy for each individual is then to wait for others to take the chance and switch first, and switch himself only when the number of those who have already switched has reached a critical level. Everyone of course adopts much the same strategy, the critical mass is never reached, and the result is that no one ever switches. Everyone then continues to use a unit of account that no one really wants, and that despite the fact that everyone may be perfectly free to switch over to demonstrably superior alternatives. Offering a new unit of account is not the same as offering a new loaf of bread—producing better bread presumably suffices to win over those who currently obtain theirs from the state, but offering a better unit of account does not. Simply *allowing* agents to use an alternative unit of account is not enough to get them to *adopt* it; something more is required than the introduction of new units of account or the abolition of legal restrictions against competing ones.[2] What is needed is a reform package that takes account of these network factors, but that also allows the maximum possible role for the market forces on which a successful monetary and banking system depends.[3]

Stabilizing the Value of Currency

The Need for Immediate Monetary Stabilization

Perhaps the most urgent need in many countries in the former Soviet empire is to end inflation and stabilize the value of the currency. If the best way to destroy the capitalist system is to "debauch the currency," as Lenin reportedly said (Keynes 1919, p. 77), it is also true that one can never hope to establish a market economy on a sound basis without ensuring that it has a stable currency. Inflation injects "noise" into the relative price signals that

[2]Again, to anticipate any misunderstanding, let me state that I fully support the removal of legal restrictions on competing private currencies, and I have nothing against the introduction of new units of account. However, it seems to me that advocates of new currencies or currency competition have never come to terms with network factors, and the failure to do so would appear to be an important reason why so many (otherwise relatively) market-friendly economists have been so lukewarm about competing currencies (see Dowd and Greenaway 1993).

[3]There is no point reiterating here the arguments for free banking that are covered in detail elsewhere. The interested reader might take a look at White (1984, 1989), Dowd (1989), Glasner (1989), or Selgin (1988b).

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markets give out to guide resource allocation decisions, and distorted price signals lead markets to malfunction and, in some cases, to break down completely.

Damaging as inflation is, both economic theory and experience indicate that it is relatively simple to stop it. It can be stopped by a monetary reform that imposes some discipline on the issue of money and reins in the excessive monetary growth that is at least the proximate cause of inflation. One way to do so would be to impose a monetary growth rule on the central bank, but a better solution is to make the currency convertible.[4] The price of the currency would then be fixed against something else, and with the price fixed, the issuer(s) would have no control over the quantity. The quantity in circulation would consequently be determined by the demand to hold it, and any amounts in excess of that demand would be returned to the issuer(s) for redemption. The price level would then be determined by the relative price of the "anchor"—the commodity or asset whose nominal price is fixed—against goods and services in general, and the trick is to choose an anchor that would generate a stable nominal price level by having a stable relative price against everything else.

In the past, such monetary reforms usually involved the reestablishment of the gold standard, and were remarkably successful. The historical evidence clearly indicates credible reforms to make currencies convertible can eliminate even hyperinflation, and can eliminate it very rapidly indeed. In the early 1920s, most of Eastern and Central Europe was ravaged by inflation. Germany, Austria, Hungary, and Poland—all countries then suffering from hyperinflation—implemented radical monetary reforms that ended their inflations within a short period of time (Sargent (1986, p. 115). These reforms reestablished the gold standard and reinforced the credibility of the commitment to peg the price of gold by limiting or prohibiting the government's right to borrow from the banking system. In each case the inflation was apparently over well within a month, and in several cases virtually overnight (see Bresciani-Turroni 1937, p. 334).

The same period also saw more moderate inflations cured by similar reforms in France in 1926 and Czechoslovakia in 1919. In both countries inflation stopped very rapidly once a credible monetary reform program was announced, and the key elements in each

[4]Convertibility is superior to a Friedman-type monetary rule in various respects. It has a far better track record; it has an automaticity that the monetary rule lacks, and therefore avoids the public choice and other problems of discretionary management; and it avoids the slippage between target and performance that can occur when the meanings of monetary aggregates change, and which in practice has plagued monetary rules whenever they have been tried.

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case were the restoration of the gold standard and the adoption of legal restrictions against government borrowing from the banking system (see Sargent 1986).[5]

A Currency Board to Stabilize the Value of the Currency

What is required, then, are monetary stabilization programs that can be implemented quickly and easily. An attractive option is to set up a currency board as suggested recently by a number of writers.[6] A currency board is an institution that issues and buys back the domestic currency on demand at a fixed price in terms of some foreign currency, but that also observes a reserve ratio so high that the currency it issues can be considered almost perfectly sound. The board's sole function is to satisfy the public's demand for currency. One can think of the board as providing hand-to-hand currency and, perhaps, redemption media to be used by the commercial banking system, but it would not issue deposits as such.

Currency boards typically hold reasonably safe assets that are dominated in the currency to which the domestic currency is pegged, but that also bear some pecuniary return (for example, treasury bills). The reserve ratio is usually over 100 percent in case the prices of these assets should fall (as when foreign interest rates rise) and inflict losses on their holders. The excess over 100 percent, therefore, provides a cushion to keep the board's net worth positive should it suffer any losses on its assets. The board would make profits equal to the difference between the net earnings on those assets and its own operating expenses, and experience suggests the latter should be about 1 percent of the value of assets (Hanke and Schuler 1991a, p. 4). Any profits above the level needed to maintain the board's reserve ratio could be remitted to the government as payment for the board's assets, which the government itself would have to provide

[5]The evidence also indicates that these reforms were not followed by the chronic unemployment problems that Phillips-curve analysis would predict. In Poland and Germany, for instance, unemployment actually *fell* following the monetary stabilization (Sargent 1986, chap. 3), and so too did unemployment in France after 1926. There are apparently no figures available for Hungary or Czechoslovakia, and the only country where unemployment actually rose is Austria, where it was rising already. It is hard to extrapolate from these experiences to predict what would happen to unemployment if comparable reforms were carried out today in the former Soviet bloc. My own guess is they would be followed by relatively rapid recovery once markets could start operating properly—remember Germany in 1948—but no one can be sure, and it seems to me that these economies are so messed up anyway that their finance ministers have no real option but to press ahead and be dammed.

[6]See, for example, Carrington (1992); Hanke and Schuler (1991a, 1991b); Schuler and Selgin (1990); and Schuler, Selgin, and Sinkey (1991).

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when it established the board.[7] The board would need to be safeguarded in various ways against the danger of political depredation.[8] It would therefore own the assets it holds for as long as it existed, and most of those assets would be held abroad where they would be safe from plunder. The board would also be legally independent, perhaps with a legal seat in another country, and with its directors serving staggered terms and a number of them being foreign nationals appointed by foreign institutions (for example, specified commercial banks) that would not be accountable to the domestic government.[9] The currency could be protected further by prohibiting the government from borrowing from the domestic financial system.[10] The appropriate peg for the domestic currency would be a strong Western currency, and perhaps the best one for any country in the former Soviet bloc would be the Deutsche mark.[11]

Currency boards are ideal for governments that seek a quick and effective means of establishing the stable monetary conditions that are essential for economic recovery. With a currency board, there is virtually no room for discretion, because the monetary system operates more or less automatically. Currency boards are independent of government and are well protected against the danger of political interference. The currency they issue is fully secured by

[7]From the government's point of view, the main expense of the system would therefore be the operating cost of the board—the government would provide the board with its assets, but would still get the return it would have obtained from them minus the operating cost of around 1 percent. Such costs can hardly be considered excessive, especially in view of the monetary stabilization benefits they would bring. The only problem in practice might then be for the government to obtain the foreign securities to set up the currency board in the first place, but one would imagine that a credible commitment to embark on such a reform would produce increased confidence on which the government could rely for loans of the securities it would need. This of course would be especially so if the monetary and banking reforms were carried out in conjunction with privatization, price liberalization, and fiscal reforms to revive economic life and put government finances on a sound basis. For any government committed to genuine reform, the currency board would be pretty much self-financing.

[8]Adequate safeguards are essential if the reform is to be credible, and credibility is critical if private agents are to build the new regime into their expectations of the future and adjust in the least costly way. If private-sector agents do not believe the reform will last, they will continue to anticipate ongoing inflation and act accordingly, and many of the benefits of the reform would be lost. Agents would still be reluctant to commit themselves for the future, they would be reluctant to supply goods to the market because they anticipated further price rises, they would still have difficulty reading price signals, and so on. A reform that lacked credibility might still be able to deliver price stability, or something like it—if it managed to last—but it would do so at a potentially much higher cost.

[9] For more details on how the currency board might operate, see Schuler, Selgin, and Sinkey (1991) and Hanke and Schuler (1991a, 1991b). The latter also provide a draft law for Bulgaria on pages 28–29 that could provide the basis for legislation anywhere else. My only reservations—

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sound foreign assets and is effectively as secure as the foreign currency to which it is anchored. Currency boards are very easy to establish—all that is required is that the legislation be passed to set up the board, the directors be appointed, the right to issue currency be transferred to the board from the existing government bank of issue, and the board be provided with its assets by the government.[12] In sum, currency boards can be established very quickly if there is the political will to do so. They also have a proven track record, and have worked well even under the most unstable political conditions (see Hanke and Schuler 1991a, p. 5).

Competition for the Currency Board

Unlike historical currency boards, the one proposed here would have no exclusive right to issue currency. There would be complete freedom to issue currency subject only to laws against the unauthorized copying of the currency issues of others and subject to the commercial law that would provide for the enforcement of legally binding promises, such as the promise to redeem currency on demand. New issuers would therefore be allowed to issue their own currency. But given the network problems already mentioned, it is likely that the only ones that would gain any major acceptance would be those denominated in the existing (and now stabilized) unit of account. Like historical free banking systems, there would be one widely accepted unit (or medium) of account—a role usually performed by a gold-defined unit of account in the past[13]—but there would in time be multiple issuers of media of

though they are important ones—is that the legislation should explicitly eschew any monopolistic privileges on the part of the currency board, and that it should stipulate a sunset clause that would provide for the board to be liquidated when there was no longer any need for it. The reasons for these provisions will become apparent later in the text.

[10]Such a provision would prevent the government from running up debts in the domestic currency, and then being tempted to avoid repayment by intervening later to devalue the currency or abolish its convertibility. The historical monetary reforms discussed earlier all incorporated such measures, and it would be most unwise to omit them. Even if later governments turned out to be "well-behaved"—and one cannot assume they would—such measures would nonetheless contribute to the success of the reform by strengthening its credibility.

[11]If the country concerned picked the currency of its major Western trading partner, then it would also obtain the benefits of maximizing the stability of its real exchange rate in international trade. The main trading partner of any Eastern European country once it has adjusted to free (?) international trade would be Western Europe, and given the exchange rate bounds of the Exchange Rate Mechanism (ERM), picking the mark would promote real exchange rate stability with the whole European Community (EC). Picking the dollar or the yen instead would stabilize real exchange rates with the United States or Japan, but those gains would be more than offset by the losses from the instability of the real exchange rate vis-à-vis Western Europe.

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exchange of one kind or another whose issues would be clearly distinguishable from each other.[14] To gain acceptance, however, any private currency would have to be able to compete with that issued by the currency board, and perhaps the main requirement to be able to do so is that the private currency be regarded as of comparable soundness. Since no one would normally choose any currency with a significant default risk over the virtually default-free currency provided by the currency board, private currency would gain acceptance only once its prospective issuers had established themselves as sound and reputable financial institutions in the domestic economy.

One would imagine that the first commercial banks to make headway with the issue of private currency would be the large foreign banks that are already setting up branches in Central and Eastern Europe and are increasingly well known there. In the course of time domestic banks would also establish themselves, and they too would issue their own currency to compete with that issued by the currency board and the foreign banks. In time one would also expect the commercial banks—domestic or foreign—to out-compete the currency board in the issue of currency. Commercial banks would eventually establish nationwide branching systems, and each branch would take in the currency of other issuers and hand out its own currency over the counter to the public.[15] These banks would be able

[12]One common objection is that these governments may not have the initial assets with which to endow the currency board in the first place, but as noted already, the government can always borrow the necessary assets if its overall reform program is credible. If it lacks the credibility to do that, then its real problem is its own reform program, not its current lack of assets as such, and it will continue to face severe finance constraints until it gets its act together.

[13] In the United States, for instance, the dollar used to be defined as a particular weight of gold. A dollar note was then only a claim to a dollar (that is, the amount of gold just specified), and not a dollar per se. Under the system proposed here, the unit of account would be initially defined for legal purposes as the amount of the foreign currency implied by its exchange rate, but as the text goes on to explain, its legal value would eventually be market-determined.

[14] While this arrangement might sound unfamiliar, it only appears so because we are used to thinking in terms of a single monopoly issuer of currency. Under a typical historical free banking system, on the other hand, each bank took the commodity-defined unit of account—usually some amount of gold—as given, and issued convertible exchange media denominated in that unit of account. There were (external) economies of scale—network economies, to use the term in the text—in the use of the unit of account, but there was no indication of any tendency toward natural monopoly in the provision of financial instruments denominated in that unit of account. The reader is referred to the various case studies of historical free banking collected in Dowd (1992a).

[15]It is in each bank's own interest to replace competitors' currency with its own, so it will always hand out only its own currency over the counter. At the same time, a bank will also accept the currency of other banks (provided they are considered sound) and then return

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to use their conveniently situated branches to keep their own currency in circulation, and though it may operate some branches, the currency board would not be well placed to compete because of its own rigid operating rules. (Remember that the board is not designed to compete in this sort of market, and it would lack the incentive and institutional flexibility to do so.)

The Eventual Need to Liquidate the Board

The time would therefore come when the currency board's market share would fall to negligible levels and the board itself would have no useful further role. The legislation establishing the currency board ought to anticipate this development by incorporating an explicit "sunset clause" that would allow for the automatic closing of the board when it ceased to have any further use. The legislation might say, for example, that the board was to be closed three months after its share of the total currency outstanding over the past two months had fallen to 5 percent. It is important that the board be liquidated and not allowed to continue once it has ceased to serve any useful purpose. The board would not only be redundant, but its rigid institutional structure would generally make it inefficient as an asset manager, and it would be better that it be dissolved so that the resources under its control could be reallocated. Perhaps the best option would be simply to have the board automatically dissolve after its currency share hits the stipulated threshold and have its assets sold off with the proceeds returned to the government.

The main reason for liquidating the currency board is not because it is either useless or inefficient, but because a future government might use it as a platform to establish some form of central banking. The history of currency boards very much bears out this concern. There was (and still is) a tendency to regard currency boards as transitional arrangements between the earlier (relatively) free banking systems that preceded them and the central banking systems that replaced them. A central bank is viewed as necessary to any but the most insignificant of countries, and a central bank, like a national parliament or in many cases a national airline, is regarded almost as a symbol of a country's sovereignty. As a result, virtually all historical currency boards were eventually replaced by central banks, or were transformed into them, and the transition to central banking was considerably eased by the argument that the existence of the currency

it to the issuer. Doing so not only enables it to replace the other banks' currency with its own, but the historical experience suggests that competitive banks would find it in their mutual interest to accept each other's notes and arrange for returns via a formal clearinghouse (see White 1984, Selgin 1988b, and Selgin and White 1987).

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board already conceded the government's right to go further if it wished and established a central bank. The money-creation powers of the central bank inevitably invited political interference, and the central bank to a greater or lesser extent always succumbed. Convertibility constraints against the issue of money were gradually relaxed, and eventually abolished altogether, and the central bank was turned into an engine of inflation.

If the new monetary regimes of the old Soviet bloc are to avoid the pitfalls into which their counterparts in the West and elsewhere have fallen, it is very important that their currency boards be only transitional arrangements that result in fully private systems of money and banking with no government presence that could be used to undermine their monetary systems later on.

The Danger of Imported Monetary Instability

The monetary system by this stage would still have one major weakness: the currency would only be as sound as the foreign currency to which it was tied. Should the issuer of that foreign currency inflate, the domestic currency would have to inflate with it because the issuers would still be committed to maintaining its exchange rate with the inflating foreign currency. This danger to domestic monetary stability should not be underrated. Even the Bundesbank—arguably the best of the major Western central banks in terms of its inflation performance—has a good record only in comparison with that of its counterparts, and its record in absolute terms is actually quite poor judged by the more appropriate yardstick of price-level stability. Nor can one assume that the Bundesbank would be able to maintain even this poor inflation record. The limits to its much-vaunted independence from the German government have become much more apparent in the past couple of years, and the German government is in any case now committed by the Maastricht Treaty to replace the mark with a new common currency by 1999. The common currency is supposedly to have a stable value, but one has good reason to be skeptical that this commitment will be honored. The issuers of most existing currencies are also committed to maintaining their values, but that "commitment" still does not prevent them from inflating their currencies, and there are good reasons in the Western European context to doubt the value of any commitment to price stability. The fact that much of the drive for a European central bank comes from dissatisfaction with the (relatively) conservative policies of the Bundesbank can only imply that the other European monetary authorities want more inflationary policies, and there is the ever-present danger that the financial

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problems of the EC will lead to it pressuring the "independent" European central bank for cheap loans to be financed by printing money (see Dowd 1990).

The Value of the Currency Determined on the Market

The solution is to look to the market rather than the political authorities to safeguard the value of money. The political authorities should be allowed only a very temporary power to legislate or otherwise control the value the currency—the power needed to clean up the mess that they or their communist predecessors have created—but denied all powers over the currency once monetary stability has been established. Instead of specifying what the value of the currency should be, except at the beginning, the legal framework would allow the definition of the currency in terms of goods, services, foreign currencies, or whatever to be determined on the market. It might say, for instance, that the value of the ruble is initially so many marks, but private agents would be allowed to use their own "brands" of the currency if they wished to do so. If the currency is the ruble, equal in value to so many marks, they might issue "new" rubles or "superior" rubles, or whatever they choose to call them, equal in value to anything they want.[16] They could issue them with values pegged to pounds, dollars, the CPI, or anything else, subject only to the constraints that they must make their own brands distinguishable from existing ones, and they must not violate existing contracts. Let us now consider each of these requirements in turn and their implications for the behavior of the banks.

The first requirement—that private-money producers differentiate their brands—prevents banks from issuing an inferior currency (for example, one pegged to something that generates more inflation, or perhaps one not pegged to anything at all) that they can pass off as if it were the same as the existing brand(s). This requirement is important if issuers are to have sufficient incentive to protect their

[16]The monetary system would therefore be an indirectly convertible one in which the banks redeemed their currency with a redemption medium that was something other than the good (or basket of goods) whose nominal price is held fixed. Indirectly convertible systems are perfectly feasible, but the reader is referred elsewhere to more detailed discussions of how they work (see, for example, Coats 1989, Dowd 1991b, and Yeager and Woolsey 1991). If the objective is to maximize price-level stability, the best anchor whose price should be stabilized is one based primarily on the basket of commodities and services of which the CPI represents the price. This anchor would have an almost perfect correlation with the CPI itself, so stabilizing its nominal price should yield a very stable price level (see especially Dowd 1992b). For our purposes in the text, it merely suffices to establish that the preferences of currency holders win out, and if they want price-level stability maximized, then that is what the banks will provide. How the banks do so is then a technicality, albeit a very important one.

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currencies, but is really only the same as requiring that brand names be legally distinguishable. If I can produce autos that look like BMWs, say, but are of inferior quality, and I am also allowed to pass them off as if they were genuine BMWs, then my ability to undercut the genuine BMW producer will obviously make it very difficult for him to maintain his quality, and there is a danger of quality standards falling continuously as the two of us fight it out for market share. The solution, of course, is to protect the genuine BMW brand name by penalizing those who use it as a cover to sell a different product. If that is done, car producers can compete on a sound playing field and the public will get the quality of product it demands, and there will be no tendency for competition among producers to lead to falling quality standards. So it is with the currency. If I was allowed to pass off an inferior currency as if it were identical to an existing one, competition among producers would lead to the progressive deterioration of the real value of any guarantees, and the value of the currency would fall to its ultimate marginal cost (about zero) in the competitive hyperinflation scenario sometimes described in the literature (see Friedman 1960, p. 8).

If brand names were protected—if a particular brand of ruble had a particular definition in terms of commodities or something else—then anyone who issued exchange media denominated in that brand of rubles would have a legal obligation to maintain their price at the level implied by the commodity definition of that ruble brand. Any issuer who failed to honor his commitment would be in default of contract and open to the appropriate legal penalties, assumed to be high enough to discourage default unless the bank was genuinely insolvent. Once this first requirement was satisfied, different banks would be free to compete with different brands of the existing currency. One bank might offer a brand with a convertibility guarantee chosen to stabilize the price level, while another might offer one that would lead to a small amount of inflation. Each brand would have an implied (expected) price-level path attached to it, but brands would otherwise be similar.[17] Competition for market share would consequently lead banks to converge on the brand—price-level path—most preferred by the public. The path of the price level over time is thus driven by public demand as expressed through the public's willingness to hold different brands of the currency. If the

[17]A new brand must have the same value as the old when it is introduced, but it would imply a different rate of price-level change over time. One that did not have the same initial value as the existing brand would be incompatible with its network, and that network would therefore function as an entry barrier against it.

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people desire zero inflation, as they probably do,[18] then the banks' competition for market share would lead them to offer the public exchange media denominated in a brand of the currency that implies zero inflation.[19] No other brand of the currency would be able to survive in competition with it, and so one would only observe that one brand in equilibrium. It is the threat that inferior banks might lose their market share to banks offering a superior brand that would keep any individual bank or group of banks in line and compel them to provide the brand the public desire. People would always be able to offer alternative brands, but the only circumstance in which a new brand would out-compete the old is if the old one provided an "inferior" price-level path (that is, one the public did not want).

The other requirement is that issuers honor any legal commitments they have freely entered into. This constraint has several important implications. One, already mentioned, is that a bank that refused to redeem its exchange media when required to do so would be vulnerable to the penalty for breach of contract. It would therefore have considerable incentive to honor its commitment to buy its issues back, and a law of reflux would then operate to ensure that exchange media were roughly compatible with their equilibrium values as implied by the particular brand of the currency.[20] Another implication

[18] Some writers have argued, however, that the public would prefer deflation to price-level stability. Friedman (1969) suggests that the optimal path is a rate of deflation roughly equal to the rate of interest, and Selgin (1988a, 1990) suggests a "productivity norm" by which the price level would move with changes in productivity, and which would therefore fall in the presence of productivity growth. These arguments deserve serious scrutiny, but it seems to me they both ultimately fail. I would refer the reader to Dowd (1991a) for the detailed arguments, but whether those arguments are correct or not is in a sense not particularly important. What *is* important is that the system delivers an optimal price-level path by catering to currency holders' desires. If I am wrong and Selgin is right, then free banking would deliver an optimal price-level path that would normally involve deflation. If I am right and he and Friedman are wrong, then free banking would deliver an optimal price-level path that would involve price-level stability. Who is right and who is wrong is insignificant—what matters is that we would get the optimal price-level path anyway, whatever that might be.

[19]One counter-argument raised by Jerry Jordan in his discussant's comments is that the public may have no preference for any particular inflation rate, and he points to opinion polls that suggest that members of the public have different preferred inflation rates. I am inclined to the view that people do want zero inflation, or something close to it, and I am skeptical of opinion polls that often ask inappropriate questions and have no safeguards to ensure that people give consistent, economically rational answers. To give but one example, polls typically suggest that the current rate of inflation is too high, but that the public also wants lower interest rates in the short run, which usually requires higher monetary growth and higher inflation in the longer run. Poll preferences are thus normally inconsistent, and I am somewhat sceptical of them.

[20]In effect, any bank would be committed to buy and sell its currency at a fixed price on demand. Any excess supply would therefore come back—hence the term "reflux"—to the

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is that it would severely restrict banks' ability to change the brand of the currency, and this restriction in turn should further help to promote public confidence that the banks would not introduce gratuitous or harmful currency reforms. Imagine, for the sake of argument, that a bank wished to inflate its currency for some reason, so it announced its intention to replace the existing brand with one that would generate the inflation it desired. It would be immediately constrained by past commitments, of course, and it could not unilaterally change the meaning of the term ruble in pre-existing contracts without exposing itself to lawsuits from creditors who (rightly) considered themselves defrauded. The bank would therefore have to provide its customers with the required advance notice, which could be very long, and to the extent that the latter preferred to stay with the old brand, the bank would either have to offer them business denominated in the old brand, offer them compensation to switch over, or see them go elsewhere. In the first case, the bank would end up having to abandon its plan, or incur the expense of operating on two brands simultaneously; in the second, it would lose out from the cost of compensation; and in the third case it would lose its market share. Any or all of these cases could occur, and the bank would have to pay some penalty in any of them. Even if the bank could maintain its market share by compensating its customers, the very fact that it would have to compensate them because of their preference for the existing brand would put the bank at a competitive disadvantage, and the bank would not be able to maintain the new brand in the longer run. Remember that it is the public's preferences that would be decisive, and not those of the bank(s).

In any case, there is no particular reason to suppose that an individual bank or group of banks would actually prefer inflation even if it could keep its market share at a low or negligible cost. Inflation (or, for that matter, deflation) would add to its own accounting costs even if it was fully predictable. Inflation (or deflation) never is predictable, of course, so the bank would also suffer from the noise and related problems created by its own inflation. These costs might be bearable if inflation generated sufficient benefits to offset them, but the benefits of inflation to the issuer, such as they are, come primarily from "catching out" those who did not anticipate the inflation, and the bank could hardly engineer a "surprise" inflation

issuer for redemption. The only circumstance where the value of a bank's currency could deviate significantly from this level would be where the bank itself failed, but even in that case, we would still expect other banks to pick up the failed bank's market share, and the value of most of the currency stock would still be at the normal equilibrium level.

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precisely because it would be constrained by its own past commitments. Those commitments would force it to announce its intentions well in advance, and its announcement would warn off those it hoped to catch off-guard. It turns out, then, that a competitive bank (or group of banks) would almost certainly be unable to engineer any price-level path other than the zero inflation desired by the public, but it is very much doubtful that such a bank would want any other path than zero inflation anyway.

The idea of entrusting the value of the currency to the unfettered market might sound unorthodox, but there is no reason to distrust it, and there is certainly no good reason for preferring to give the task of protecting the currency to the politicians instead. One does not put the predator in charge of the chicken house.

Banking and Financial Reform

The measures outlined above are necessary but by no means sufficient to establish the foundations of a sound, free banking system. If they are to succeed, they must be underpinned by other reforms that are essential to any well-functioning market economy. Foremost amongst these is the establishment of clearly defined property rights. The bulk of the property currently belonging to the state or its collectives needs to be privatized, and privatized as soon as possible. Those who obtain it must have a clear and unambiguous title to it, and that title must also include the unrestricted freedom to sell, lease, rent, or use property as collateral to obtain loans. The establishment of solid property rights would also allow individuals the wherewithal to start or expand their own businesses, and to pledge their property as security for bank loans. It would therefore promote an entrepreneurial class from which would come much of the demand for bank credit, but it would also give that class the means to obtain that credit. The result would be a growing effective demand for the asset services provided by banks, and profit opportunities for those banks that stepped in to meet that demand.

The banking system itself would need a sound framework of law in which to operate. By and large, banking laws should be governed by the same principles that underscore good commercial law in general. Banks and firms generally need to have well-defined legal identities modeled on Western corporate law, and there need to be clear notions of default and bankruptcy and of the rights and obligations those conditions imply. Entry to the industry should be free and open to all who satisfy certain basic standards. Foreign banks should be free to open and operate on the same terms as domestic banks. Banks should be free to maintain branches wherever they choose. They

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should be free to engage in any business they want, including insurance, stock underwriting, real estate, and foreign exchange. They should be free of any legal restrictions regarding the reserves they keep, their capital adequacy, the interest they charge or pay, the loans they make, and the deposits they accept. There should be no government-sponsored lender of last resort to protect the banks, and no official deposit insurance scheme. Such schemes only undermine the banks' incentives to maintain their own financial health, and substitute taxpayers' funds for the equity that the banks should maintain themselves. Finally, like most other major institutions, banks should be required to

> publish accurate financial statements frequently. The financial disclosure requirements should be modelled after American and British practice, not after German and Swiss practice that allows banks to keep "hidden" reserves off balance sheets. Stringent disclosure requirements plus the ordinary penalties on fraud should keep embezzlement at an acceptably low level [Schuler, Selgin, and Sinkey 1991, p. 10].

The process of building up the banking system could also be enormously facilitated by foreign banks, and the government should do nothing to discourage them. They would have the advantage of being experienced and already well established in their own countries. They would have their own adjustment problems, of course, but they may well have the initial edge over domestic institutions that would start off with little or no experience, capital, or reputation. A large influx of foreign banks would bring in much-needed bank capital, leading to a more rapid development of the banking system, and a more rapid growth in bank lending. It would also introduce Western banking and financial practices and promote the spread of basic accounting skills, of which all the former Soviet economies are woefully short, and it would give domestic banks clear models from which they could learn good practice more quickly and at less cost than might otherwise be the case.

What applies to banks also applies to foreign firms in general. Foreign direct investment facilitates the rebuilding of the economy's capital structure, promotes the introduction of Western practices, and assists the general shaping up of domestic industry. Domestic firms badly need capital, but there is as yet relatively little of it to be obtained in their own economies and it could take many years before domestic supplies of capital are large enough to meet their demands. Governments should not be afraid to encourage foreigners to invest, and they should resist any xenophobic reactions to foreign "domination" of the economy. The more foreigners who wish to come in and

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"buy up" the country, the better.[21] Foreign investment is an important part of the growth process for countries that need more capital than they can generate themselves, and it implies that investors abroad have confidence in the economy and are willing to invest there because they believe its prospects are good.

Foreign direct investment is desirable not just because Western capital is needed to build factories, introduce Western business practices, restore the infrastructure, and so on. A combination of factors—most industries chronically uncompetitive on world markets, relatively little private property that could be sold off to foreigners, few foreign currency reserves, and a desperate need for Western imports of all kinds—means that these countries have no option but to run up large current account deficits, and financing those deficits requires correspondingly large capital account surpluses (that is, net investment from abroad). Significant amounts of foreign investment are therefore essential if consumers are not to go short of the food and other goods they need, and if industry is not to be starved of raw materials and other necessary imports. A liberal approach to foreign investment can thus provide a major boost to accelerate the overall recovery process. Without it, consumers could go short of basic goods for years, industry will be crippled for a long time by financial constraints, and economic recovery will be very painful and very slow.

Conclusion

It might be useful to say something about the timing of the various measures discussed here and how they relate to the overall reform process. Two of the reforms suggested—the establishment of a solid foundation of property law and all that that entails, and a monetary stabilization package—are absolutely basic to the whole reform program and should be implemented as quickly as possible. Delaying these reforms will only lead to further economic decline, and until they are attended to, any significant economic recovery will be virtually impossible. As mentioned already, the monetary stabilization legislation should also ensure adequate protection for the currency board it was setting up, and the same legislation should also authorize the complete removal of any remaining controls on foreign exchange or foreign investment and of any restrictions against the use of alternative units of account. The establishment of a sound foundation

[21]Xenophobic reactions to foreign investment are nothing new, but very misguided. As Selgin, Schuler, and Sinkey (1991, p. 17) point out, "For more than a century after independence, British investments in the United States were so large that some Americans feared British economic domination. Nothing of the sort happened; in fact, British investment sped America's rise as the world's greatest industrial nation." America's current generation of Japan bashers would do well to take note.

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of commercial and banking law should follow as soon as possible afterwards, and as with property law, legislators could speed up the process by borrowing large chunks of it from successful legislation in the West. If these measures are to be fully effective, however, it is very important that they form part of a coherent overall recovery program that would also involve the privatization of the mass of state property inherited from communist days, the deregulation of prices and wages, and the rationalization of the public sector and its finances. The reform of the monetary and banking system is essential, but it is not sufficient on its own, and it is only when all these measures have been attended to that one can be confident of having laid the foundations for a secure and prosperous market economy.

Despite the needs of the moment, it is very important that those responsible for reform in Eastern Europe resist the temptation to become totally preoccupied with short-term solutions and spare no thought to their longer-term consequences. It goes without saying that the short term must be addressed, but it is also important to lay down sound foundations for the future. In the longer run, economic prosperity does not depend on the choice of particular policies by particular governments so much as on the choice of the institutional structure within which everyone has to work. That choice has to be made now, and it is vital to get it right. As many would-be reformers are all too aware, it is much easier to make the right institutional choice in the first place than try to change it once a mistake has been made and then cast into stone.

In trying to make these decisions, it is also important that reforming governments be discriminating in what they copy from the West, and nowhere more so than in money and banking. The West offers many models that could be usefully copied—many of its legal codes, business practices, and so on—but it is also the source of many mistakes to be avoided, and the biggest of these is the institution of central banking. Central banking in the West has now produced apparently permanent inflation, and while it might make sense to peg former East bloc currencies to a (relatively) strong Western currency as a short-term crutch, in the long run ex-communist countries (ECCs) should aim to do better and put their currencies on a firm, noninflationary basis. The former Soviet countries should also avoid the disastrous mistakes that Western countries have made by other interventions in banking. The worst of these was the establishment of federal deposit insurance in the United States, which has now resulted in the de facto nationalization of much of the U.S. banking industry and in a public finance catastrophe unparalleled in world history.

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For all its present problems and immediate dangers, the present state of flux offers many opportunities for worthwhile reform that are unlikely to recur for a very long time. If policymakers in ECCs are wise enough to embark on market-oriented reforms and to avoid the pitfalls into which the West has fallen—in money and banking especially—then there is every chance that the former East bloc countries could not only reach Western standards of prosperity, but in the long run could eventually surpass them.

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Credibility, the Monetary Regime, and Economic Reform in the Former Soviet Union

Peter J. Boettke

I find myself in substantial agreement with Kevin Dowd's (1993) discussion of money and markets in economic reform. His discussion of the network externality problem with the free banking alternative raises the pertinent theoretical question that advocates of free banking must address in order to make their policy solution more attractive to skeptics. On the other hand, his discussion of the failure of monetary growth rules to provide adequate institutional constraints against the public choice problems associated with government discretion logically point to a market-based monetary regime as the only viable solution. In addition, Dowd raises some very interesting questions concerning possible shortcomings of the currency board alternative for reforming the monetary system in the former socialist economies. In particular, Dowd points out that the currency board would have to develop safeguards "against the danger of political depredation." Historically, currency boards have always been an intermediate step on the way to a central banking system.

It is precisely this point, however, that I think Dowd could stress more forcefully. The issue of establishing a binding and credible commitment to sound monetary policy is not a footnote issue, but is perhaps the central issue in monetary reform.

The Failure of Perestroika

Perestroika as a policy of economic restructuring and renewal failed miserably.[1] The economic crisis that Mikhail Gorbachev inherited

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[1]See Boettke (1993) and Goldman (1991) for a general discussion of the failure of the reform effort from 1985 to 1991.

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grew more acute and the political system simply fell apart. In large part, the official debacle of the Soviet system was a necessary precondition for fundamental reform to take place. But, understanding the debacle should still be a priority.

Perestroika failed because it was not attempted. From 1985 to 1991, Gorbachev introduced at least 10 major economic programs under the banner of perestroika, but not a single one was ever implemented. Moreover, even the policies that were introduced represented half-measures and incoherent policies. Most of the Gorbachev reforms were incentive incompatible with the development of the economic forces needed to resurrect the Soviet economy. Gorbachev's efforts, however, failed not only because of the incentive incompatibility of most of the reform decrees, but also because of the adverse reputational effect of constantly shifting and changing the status of reform policies. No one was sure whether a Gorbachev liberal zig today would not become a more repressive zag tomorrow, and as a result nobody had any incentive to invest in the official economy.

Nowhere was this felt as directly as in the monetary system itself. The Gorbachev era was characterized by a flight from the ruble. As the official economy sank deeper, individuals selected out of rubles to engage in exchange. Rubles, for a long time externally inconvertible, increasingly became domestically inconvertible as individuals found it more difficult to purchase goods and services with ruble notes at state stores.[2] Hard currency was sought in the black market to expand the array of choices available to consumers, and complicated barter arrangements emerged to coordinate the plans of economic actors. This unofficial exchange system came to dominate the economic landscape.[3] The competitive duality between the official sector and the unofficial sector allowed individuals within a desperate economy to survive—some even to prosper. But, it also convincingly demonstrated the extreme failure of the Gorbachev reform efforts. Individuals preferred to incur the costs associated with a complicated barter system rather than deal with the official monetary system that was no

[2]It was, of course, always the case that a ruble was not always a ruble. A ruble in the possession of a Communist Party official had a much higher purchasing power than a ruble in the possession of Ivan. Thus, despite the slight discrepancy in official income between high officials and average workers, there was quite a discrepancy in the real income distribution in the former Soviet Union. Moreover, in an administratively fixed-price economy it is conceptually difficult to talk about convertibility in a meaningful manner. But, the main point is that under Gorbachev the ruble became even less of an internally convertible currency then it was before.
[3]It was estimated that only 40 percent of food, for example, was obtained through the official distribution system by 1990 (see Peck and Richardson 1991, p. 24).

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longer credible.[4] Without a well-functioning monetary system, though, systemic economic reform will continue to be absent.

Centrality of Money

In a monetary economy the generally accepted medium of exchange represents a link in all exchanges. Money, in other words, is one half of all exchanges; that is, it is the joint linking all transactions. This jointness aspect of money translates into the proposition that if policy alters the value of the monetary unit it also changes the pattern of exchanges throughout the economy, distorting the industrial structure and misleading economic actors.

The Bolsheviks knew from Marx that monetary exchange was at the heart of the commodity circulation system. The original Marxian aspiration was to abolish the commodity production system and with it monetary circulation. But, this project in Marxian economic rationalization led to the complete collapse of the economy of Soviet Russia by the spring of 1921, forcing the Bolsheviks to change course with the New Economic Policy (NEP).[5] During NEP, the Bolsheviks even tried to revert to a gold standard to renew faith in the monetary unit with the chervonets reform.

NEP failed because the government backed out of its policy commitment to economic liberalization domestically and internationally. Discretionary action by the Soviet government undermined the monetary system and destroyed any incentive that peasants may have had to market their wares. By the end of the 1920s, the "market" was simply not a secure outlet for economic actors.

The Soviet experience with economic policy provides many important insights, but perhaps none as important as the central role a stable and credible currency plays in economic development. Without such a currency, development of the productive forces of society are thwarted. Recognizing the centrality of the monetary unit in any economic system forces economists to pay particular attention to systemic questions concerning the monetary regime itself and the rules under which it operates as opposed to particular pro- or counter-cyclical policies that are suggested by advocates of either demand-side or supply-side management of the economy.

[4]See Peck and Richardson (1991, pp. 2–3; 29–33; 55; 89) for a discussion of the economic crisis in the former Soviet Union near the end of the Gorbachev period.

[5]See the discussion of the original Bolshevik project in Boettke (1990) and Roberts (1991).

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The Credibility Problem

Only if a reforming regime can convince the populace that it will honor its promise to respect their rights and create a stable environment for economic activity, will the economic liberalization reforms ever get off the ground. Conveying such a commitment, however, is the major problem in establishing a workable constitution of economic policy.

One of the major difficulties facing any reforming regime is somehow signaling to its citizens that it will honor its promise of reform and not renege. There are two strategic problems confronting the reforming regime. First, a strategic incentive game is generated by reform proposals. A policy or promise announced at one time may bring forth a response that in the next time period provides one player with a greater opportunity for personal gain by reneging rather than honoring the promise. When I am having trouble falling asleep, for example, I may attempt to solicit my wife to rub my back with the promise, "I'll rub your back, if you rub mine." However, if her soothing back rub produces the intended result, then I will be much better off by reneging than honoring my promise—since I will now be asleep. My wife, of course, knows that I will renege on the promise, and therefore, except for the kindness of her heart, will refuse to believe the promise and not rub my back.

A similar situation faces the government and its citizens when formulating public policy. Without a binding commitment to honor its promise, citizens will realize that the government may gain in future periods by reneging on the policy, and thus will not trust the policy announcements of the government unless the government can establish a binding and credible commitment to the policy.

This problem is compounded when we realize that the situation is not limited to the strategic incentives, but also includes an informational problem that may be even more difficult to overcome. Faced with a reforming government, citizens do not really know who they are playing with. The citizens' only prior knowledge of the regime was the "old way" of doing things. Reform signals a break from the past, but why should citizens believe the regime? Without citizen participation, though, the reforms will stall.

The regime's problem, then, is not simply limited to the difficult problem of solving the basic paradox in establishing constraints on its activities that do not deter its positive ability to govern. In order to get economic liberalization off the ground, the rulers have to simultaneously establish binding constraints on their behavior and signal a sincere commitment to reform to the citizenry. During war, for

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example, if his troops crossed over a large river to do battle with opposing forces, the commanding officer may order the bridge burned—thus precommitting his troops to the battle ahead by eliminating the only possible escape. At the same time, however, opposing troops witnessing the smoke have received a signal that the other side will fight a hard battle. The reforming regime must do something similar to the commanding officer's burning of the bridge to establish trust and bind itself to the liberalization policy. If it does not, then neither domestic citizens nor foreigners will have much of an incentive to invest in the economic future of the region.[6]

Monetary Regimes and Credibility

Economic liberalization demands a convertible currency. One of the main problems of the transition of the former Soviet economy to a market economy lies in the inconvertibility of the currency. A market economy requires a widely accepted medium of exchange that can purchase goods and services on the domestic market (internal convertibility), and that is easily converted into foreign currency (external convertibility) at free-market rates. The reality of the Soviet economy under Gorbachev was that the ruble was neither internally nor externally convertible. Despite the wide variety of proposals for ruble convertibility, most have in common the reliance of a central banking system to institute the reform.

Successful monetary reform, however, can be nothing short of complete depolitization of the monetary system. The reasons for depolitization of the monetary system are straightforward. Depolitization of the monetary system eliminates the inflationary ability of the government and forces government to either borrow in the capital market or raise revenues through taxation to finance its affairs.

[6]Dani Rodrik (1989) has addressed the issue of commitment signaling with regard to policy reform in a game-theoretic framework. As he sums up his argument: "At the outset of any reform, the public will typically be unable to fathom the true motivations of the government undertaking the reform. Since the distorting policies in question have been put in place by those in power to begin with, what reason is there to believe that the authorities now 'see the light'? . . . Signalling via policy-overshooting can then help reduce the confusion. . . . The more severe are the credibility problem and its consequences, the more likely it is that a sharp break with the past will be viewed as attractive" (p. 771). Therefore, if the credibility gap is particularly important, as it was in the Soviet situation, all notions of gradualism must be put aside for the appropriate signal to be conveyed. Policy overshooting can distinguish a sincere reform government from its insincere counterpart. Thus, policy overshooting will have the effect of rendering the policy reform more credible than it otherwise would be, and alleviate the problems associated with lack of credibility.

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The logic of the depolitization of money is also fairly straightforward.[7] The market for monetary services is no different than the market for other commodities. There is no need for government to "manage" money. Rather than a regulated banking system based on central bank monopoly note issue, a more viable alternative can be found in an unregulated banking system of competitive note issue.

The fundamental problem with central banking, however, is not the problem of political manipulation of the monetary unit. The real problem is that central banking presupposes the capability of state authorities to access information that is neither in their interest nor ability to gather.[8] For central banking authorities to manage the supply of money accurately, they would have to possess knowledge of the conditions of supply and demand that is not available to any one mind or group of minds. Both the political and economic problems of central banking are inherent in the institution itself.

Competitive note issue will set in motion an entrepreneurial process that will adjust supply decisions of bank managers to meet the public's demand for monetary notes. The clearing mechanism under free banking will ensure that managers will receive the appropriate signals for effective resource allocation. The clearing mechanism provides signals concerning debit and credit that follow from the bank's under- or overissue of notes. This information will cause bank managers to adjust their liabilities accordingly. Moreover, in a free banking system of competitive note issue, the return of notes and checks for redemption in base money will also provide incentives and information that is vital for the proper administration of the money supply. Monopoly note issue by a central bank simply cannot generate the incentives or information required to adequately manage the money supply. Central banks are not well equipped to know whether an adjustment in the supply of money is needed; nor are they well equipped to assess changes in the demand for notes.

Competition in note issue, however, promises all the same benefits that competition in any other commodity does. The availability of

[7]See the discussion of free banking theory in White (1989) and Selgin (1988). For a historical discussion of the operation of a free banking system, see White (1984). A key episode in White's discussion of the Scottish system is how the banking system handled the Ayr Bank failure of 1772. As White points out, the Ayr Bank, which was in operation from 1769 to 1772, engaged in reckless management and extended a great deal of bad credit through note issue. The bank's failure also led to the failure of eight other private bankers, but it did not threaten the financial system as a whole. The note exchange system that emerged in the Scottish system served as an important check against overissuance by a single bank and provided market incentives to discipline those that attempted to engage in overissue of its notes through the law of reflux (White 1984, pp. 30–32, 126–28).

[8]For a discussion of this problem with central banking, see Selgin (1988, pp. 89–107).

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substitutes will force bank managers to act prudently in forming their business decisions. Brand names will be important in the competitive process as some bank notes will become more respected than others. But as long as freedom of competition persists, then an effective administration of the money supply will result.

In the current situation of the former Soviet Union, the ruble has become basically worthless. The Russian Republic is running its printing presses 24 hours a day. Free banking offers an alternative to this monetary chaos.

Banks could offer notes backed by hard currency or some bundle of commodities or gold.[9] The banks would offer deals on ruble exchanges to attract customers. Individuals would gravitate to bank notes that were most widely accepted for market transactions. Central bank rubles would disappear, as would the institutional organs of central banking, but monetary order would emerge and the money supply would be free of the manipulation of the political process.

One final note: free banking offers an answer to the policy dilemma highlighted above concerning commitment conveyance. Eliminating government control over the money supply not only precommits the regime, it also signals to market participants that the government is sincere in establishing restraints on government's leading role in the economy. It will take such a drastic step—policy overshooting—that signals binding constraints on government action to get economic liberalization policies on the right track. Allowing competitive note issue under a regime of free banking offers the best chance for achieving the simultaneity required for conveying and establishing a credible precommitment to liberal economic reform.

Conclusion

Liberalization requires a transformation of the previous institutions and practices of the "old regime." The monetary system is central to any economic system, and, therefore, represents the most fundamental focal point of economic policy. Depolitization of the monetary system offers the best chance for the emerging market economies of Eastern Europe. Competition in note issue is not only a theoretically viable system; it represents a practical solution to the problem of precommitment and signaling that government's discretionary role in the economy has been constrained in a credible manner.

[9]A private currency board, therefore, could represent a viable alternative. But, a government-run currency board possesses severe theoretical and practical shortcomings.

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Getting the Rules Right

Jerry L. Jordan

Kevin Dowd's paper consists of several parts. In the introduction, Dowd argues that there can be no spontaneous creation of a new stable unit of account. In the next section, he explains how a currency board could be used during a transition period to stabilize prices and to allow the evolution of private money. He goes on to discuss how a private insurer of media of exchange would drive the currency board out of business and why competition among private currency issuers would ensure price stability in the unit of account. In a final section, he discusses the need to establish property rights and to extend them to foreigners. He also encourages specific legal reforms to spur the development of banking and other financial institutions.

Two fundamental principles should be kept in mind as we discuss how to structure a monetary regime for the transition to a market economy. First, money arises in a market economy in order to reduce information costs and facilitate transactions. We often use the phrase "monetization of the economy" to mean the development of markets for goods and services that had previously been produced at home. Historically, markets and money have arisen simultaneously. This role of money is poorly understood by economists, yet is critical for the operation of a market economy. In particular, fostering sound money is an important precondition for the evolution and maintenance of credit markets. The cost of starting and operating markets for credit will be much lower without the uncertainty and mistrust that invariably accompany inflationary policies.

Second, the power (or the right) to create money may be an important source of revenue, especially when a government is new and weak. Because the inflation tax will appear as a safety valve to

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release the short-run pressures that build as coalitions struggle over the resources that government controls, it is important that the inflation option be made difficult to exercise. We should seek practical approaches, through constitutional means, to limit the power of governments to debase the currency.

Money as a Determinant of Productivity

Karl Brunner and Allan Meltzer (1971) and Armen Alchian (1977) explained how every society will use some goods as money. The goods chosen will be those that economize best on the use of other real resources in gathering information about relative prices and in conducting transactions. The presence of money reduces the costs of making and clearing markets. An efficient currency based on a stable unit of account is especially important in more primitive economies that rely heavily on currency for making transactions.

Almost all formal macroeconomic and public finance analysis of optimal monetary policy ignores this important role for money. Yet the welfare triangles associated with alternative policies in those formal models are no doubt swamped by the welfare losses that occur when such policies reduce the efficiency of money in facilitating market clearing. When Milton Friedman (1969) argued for the optimal deflation rate, he implicitly assumed that markets cleared costlessly and that allowing the unit of account to appreciate over time would not interfere with the efficiency of the price mechanism. When macroeconomists argue for aggregate demand management (and against rules for price stability), they almost never take into account the cost of making the price system less efficient.

Credit markets thrive on good information and on trust among market participants. That is why our first experience with credit is usually with friends and family. Credit extension will be essential for the successful privatization of Eastern European economies. One advantage of the market system is that the market collects and disseminates information in a way that no individual or government agency can match. But the efficiency—indeed the likelihood of survival—of credit markets is much higher if the price system gives good information about economic value and if the government can be trusted to stabilize the unit of account.

If the former Soviet republics and Eastern European countries already had sound money, they would have greater wealth and fewer credit problems. Although the ultimate goal of the reform movement is to create wealth, or to raise living standards, the success of any reform will also require making credit available to potentially productive enterprises.

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Reformers should be careful when adopting our institutions. The West has endured considerable inflation in the last two or three decades. Our credit markets have flourished despite this inflation, not because of it. As a matter of record, we know that the rise of inflation has closed many long-term markets and spawned others whose only apparent purpose is to hedge the risk associated with uncertain inflation policies.

Inflation as a Source of Revenue

Debasing the currency has been a common method of taxation for a few thousand years. Considering all of the available options at any given time, history has frequently recorded instances where inflation was deliberately chosen as the least undesirable method of taxation. Unfortunately, such instances are almost always associated with war finance or with a government on the verge of collapse. A government that is limited to inflation as a primary form of taxation in peacetime has lost the capacity to govern.

Those who give advice about the optimal monetary policy must spend some time thinking about the optimal tax policy. Surely the advice to forgo the inflation tax would be more credible if it were presented as part of a realistic and comprehensive tax package.

Ultimately, the success of monetary reform will depend on the successful management of the government budget. In the former Soviet Union, or maybe even Russia currently, the government budget deficit is approximately 25 percent of GDP. It also happens that military expenditures are approximately 25 percent of GDP. Monetary creation is necessary to finance government expenditures—given the lack of debt markets, a stable currency, and so on. Monetary creation is necessary to meet the payroll of four million soldiers. We cannot assume away the problem. Until the fiscal imbalance is corrected, monetary stability requires foreign capital inflows. These countries cannot simply raise explicit tax revenue, or stop paying the armed forces. As desirable as it may be for the former socialist economies to slash expenditures and to dismantle the military forces, the only way that monetary creation can be contained during the transition is through access to foreign capital.

Money as a Network

Dowd's analogy about the telephone network is a good one. The introduction of a successful telephone network requires more than just an adequate supply of telephones. If we were told, for example, that Romania has a terrible telephone system, we would not solve the problem by contracting with a manufacturer to ship several million

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inexpensive plastic handsets to Bucharest. Similarly, giving or loaning foreign currencies will not fix the monetary systems of the transition economies. Instead, the emerging market economies need to encourage the natural tendency of money and markets to evolve simultaneously. One way is to adopt the institutions and technologies that other countries have developed.

In an important sense, however, the telephone analogy is weak. People will always have something to say, so the advantages of having a telephone system are obvious. It is not so obvious how people in the emerging market economies will benefit from a newly formed monetary-exchange system; they must first have something to trade. That is why reform must begin with the assignment and protection of property rights.

Currency Boards

As Dowd suggests, monetary reformers may want to adopt more than just the technology of their more financially sophisticated neighbors. By the use of a currency board, they might also borrow the stability and credibility of their neighbor's currency. To accomplish this, an emerging market economy in Eastern Europe could peg its new currency against one of the major currencies, such as the Deutsche mark, since this would tend to stabilize the new currency vis-à-vis the European market. In this way, a new government might import the stability of the Deutsche mark as well as the credibility of the Bundesbank without actually adopting the mark as the medium of exchange.

Ironically, Germany itself was in this situation just four decades ago. After World War II the Deutsche mark was tied to the U.S. dollar before it became a standard of value in its own right. Monetary reform in West Germany included institutions that successfully dealt with the overhang of currency from an earlier period of price controls and excessive monetary growth. It also enacted specific restrictions strictly limiting the amount of government debt that could be monetized. Although these restrictions were imposed by an occupation army, they were ratified by the German government when the currency became convertible in 1957 and are, at least in part, a reason for the relative stability of the Deutsche mark today.

Dowd is skeptical of currency boards for two reasons. First, they tend to turn into central banks. Some form of private money would evolve along with markets, even where the government did nothing more than define and protect property rights. To speed up this natural market evolution, Dowd advocates government intervention, but wants it to be temporary. Although I am sympathetic to the things that

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can go wrong when the government is a monopoly provider of money, I see little chance that the emerging democracies will adopt private money.

Because those nations are likely to adopt central banking institutions, it seems wise to consider the restraints, the checks and balances, that would increase the prospects for price stability. These include constitutional limits on the ability of the central bank to monetize government debt, limits on the size of government itself, a substantial degree of political independence for the monetary authorities, and a clear set of priorities that ensure accountability to the public.

Second, the use of a currency board and a fixed exchange rate may lead to imported inflation. This problem might be overcome with an indexed peg. For example, suppose the currency were pegged to the U.S. dollar and it was believed that the dollar was inflating 2 percent faster than the desired rate. One solution would be to create a crawling peg that allowed the domestic currency to appreciate 2 percent per year against the dollar. Of course, this approach assumes that the trend rate of inflation in the U.S. dollar is predictable. A more secure method to insure against imported inflation may be to use the exchange rate as an intermediate target to achieve a long-run goal for a domestic price index, as the Swedish *Riksbank* did in the 1930s (See Keleher 1991).

Competing Private Currencies

I am not convinced by Dowd's argument that competition among private currency issuers would ensure price stability. The paper does not mention *specific performance* and the necessity of legal institutions that will enforce contracts in the terms of the contracts rather than in some politically enforced legal tender. Without legal enforcement of specific performance, Dowd's privately issued currency system simply will not function.

Implicitly, Dowd defines a superior brand of currency as one offering more price stability and says that a type of consumer sovereignty will ensure that the inferior brands (that is, eroding currencies) will not survive. His private producers of currency are issuing media of exchange, but he concludes that competition will ensure a stable unit of account (if that is what the public wants). He asserts that this is probably the case, but offers no proof. On the contrary, the only evidence he presents points in the other direction. He argues that, in the European Community,

> the common currency is supposedly to have a stable value, but one has good reason to be skeptical that the commitment will be

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> honored. The issuers of most existing currencies are also committed to maintaining their values, but that "commitment" still does not prevent them from inflating their currencies, and there are good reasons in the Western European context to doubt the value of any commitment to price stability. The fact that much of the drive for a European central bank comes from dissatisfaction with the (relatively) conservative policies of the Bundesbank can only imply that the other European monetary authorities want more inflationary policies, and there is the ever-present danger that the financial problems of the EC will lead to it pressuring the "independent" European central bank for cheap loans to be financed by printing money [Dowd 1993, pp. 566–67].

Dowd cannot have it both ways. He simultaneously argues that the lack of popular political support for price stability means dismal prospects for monetary stability in Europe, while maintaining that privately issued currencies in Eastern Europe and the former Soviet republics will be stable because the public wants stable currencies. Dowd does not make a clear distinction between consumer preferences as expressed in the marketplace and voter preferences as expressed in the polling booth. Yet, some explanation is needed to reconcile his evaluation of the current state of monetary affairs in the EC with his belief about the public's desire for price stability.

Dowd might investigate the issue in a framework such as that used by Allan Meltzer and Scott Richard (1981) in their mean-medium voter model. One could explore the conjecture that the people most likely to vote in a democracy are better hedged against the consequences of mild inflation than is the population at large. Perhaps the less-educated, lower-income renters in society are both less likely to vote and less able to protect themselves against the consequences of inflation.

A Litmus Test for Successful Reforms

We will know that monetary reform has worked when we see substantial, voluntary inflows of foreign private equity and debt capital. If there is a substantial inflow of foreign private capital (or in countries such as Latin America, repatriation of capital), then foreign official capital will not be needed. But, if we do not see a substantial voluntary inflow of private debt and equity capital, then no amount of foreign official capital would solve the problems of these countries. Foreign official credit may even undermine incentives for rapid implementation of essential economic reforms such as privatization of government enterprises. If these countries get the rules right, they

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will see an inflow of private capital and will not need foreign official credit. If they do not get the rules right, then foreign official credit is a waste, at best.

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Is Russia Threatened with Hyperinflation?

Oleg Bogomolov

The liberalization of prices at the beginning of 1992 has been interpreted as the first real step toward a market economy. Indeed, without free prices determined by supply and demand, there can be no market; just as there can be no market without competition, private property, sound money, and strict state regulation of accounting practices and taxation. It is too late now to give advice on the sequencing of market reforms in Russia (privatization, demonopolization, and budget reform first, followed by price liberalization or vice versa). Clearly, the Russian government had neither the time nor any real opportunity to make a better choice. The central control structures were breaking up and being abolished. Many prices already had broken free since the summer of 1991. A sense of the inevitability of another jump in prices had deeply penetrated into the public consciousness, leading producers to delay deliveries of goods in anticipation of the price increases. There was clearly no hope of stemming the rising tide through administrative barriers: the result could be the opposite to the one desired (a further worsening of supplies to cities and an explosion of speculation and other abuses). Even the rationing of basic foodstuffs sold at fixed prices became a problem in view of the insufficient funds at the disposal of the authorities and the fact that the authorities themselves were too weak to force producers to deliver goods to centralized reserves at unprofitable prices.

In a word, arguments over the best theoretical path to a true market have taken a back seat to the dangerous effects of a new jump in prices and to the need to counteract these effects.

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The Price of High Inflation

The most serious threat is posed by high inflation, that is, a back-and-forth race between prices and wages in which everything becomes more expensive by 10–30 percent every month. Such inflation is dangerous because it deprives the economy and its individual participants of any stimuli for accumulation and investment, engendering a desire to expend earned income immediately and avoid the risk of investments, since it is absolutely uncertain what profit could be derived from them. What is the use of expending effort when additional earnings are instantly consumed? The indexation of incomes and deposits based on the rate of monetary devaluation does not fully insure against losses. Financial relations become more and more confused, the standard of living falls, social disparities grow, and production stagnates or even drops. This is the price of high inflation.

History provides examples of hyperinflation and of overcoming it. Tackling this problem is uncommonly difficult, but not impossible. The point is that high inflation sets in motion a mechanism of self-acceleration: the producer, in anticipation of growing costs and devaluation of revenues, calculates prices that are higher than required at the present moment well in advance. Thus the inflationary spiral continues to ratchet to higher and higher levels. It is true, however, that the rapid devaluation of excess demand held by the population (deposits at savings banks and cash holdings), as well as of the assets of enterprises and organizations in bank accounts, makes the solution of the problem of balancing the money supply and the supply of goods easier. The two- or threefold price increases effected by Valentin Pavlov, their further growth even before the onset of liberalization, and subsequent new jumps in prices following liberalization effectively soaked up at least 500 billion accumulated rubles from the pockets of the population, to say nothing of the nearly twofold reduction in consumption. A high price to pay for the economic policies of the years of perestroika.

Curbing Inflation

In recent years Yugoslavia, Poland, and some Latin American countries have to some extent managed to curb excessive inflation. Will Russia be able to do this? What new sacrifices will it require?

I think that one should not set great hopes for an elimination of the numerous deficits or the appearance of an abundance of goods on shop shelves. This was the result of liberalization of prices in Poland after January 1, 1990. The possibility of a similar result in our case is problematic, since the severely tight fiscal policies and wage freezes

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of the Polish case would be extremely difficult to implement in our case, and the more so, since no such measures are envisioned in respect to wages. In Poland, price liberalization was from the very start accompanied by internal convertibility of the national currency (free exchange of zloty for dollars at the rate set by the state for both the population and enterprises). In this manner the market had a reliable and real anchor to which prices could fix themselves. There is nothing of the kind in Russia. Moreover, the state monopoly on agricultural purchases, trade, and the manufacture of many goods will most likely in our case act to further push up prices, rather than lead to an expansion of the supply of goods. How can we fight inflation in this case?

It is already clear that after the deregulation of most prices and wages we must decisively implement a whole package of well-known measures without which the economy and, in the first instance, its monetary system cannot be stabilized. Some of these measures should have been effected even prior to liberalization; for example, the privatization of state property, the dismantling of monopolistic structures, and the creation of a competitive environment including a liberalization of foreign trade, the elimination of the budget deficit through a reduction in government spending, an improvement of the taxation system, and strict control over credit and monetary emission. We must decisively restructure the economy, orienting it toward the needs of the population and toward providing all possible assistance to entrepreneurship. The above measures require time for their preparation and an experienced and strong administration for their implementation. Then they will be capable of containing liberalized prices and restoring confidence in money.

Privatization

Unfortunately, we have neither a surplus of time nor an effective executive power that would be obeyed without objections. Under these conditions we must shy away from complex bureaucratic forms of privatization and return a part of the property confiscated by the state to the ownership of private citizens in order to lessen social discontent, localize spontaneous civil unrest caused by low living standards, and curb the growth of crime, bribe taking, and large-scale theft of property. One cannot simply rob the population through taxation and inflation (which is, in fact, a kind of indirect tax) and compel people to buy property that already belongs to them. Savings are insufficient for this. We must immediately privatize state apartments free of charge (or for a nominal symbolic price) for those who live in them and distribute land to those who are capable of efficiently

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working it. This would compensate, even if only in part, the enormous material losses of the population. All inequalities resulting from such free distribution could be corrected later through taxation on the sale and inheritance of this property.

Later, when it comes to the privatization of large-scale state property, the adult population should be issued certificates (vouchers), as is being done in Czechoslovakia (now the Czech Republic) and Poland, for a free acquisition of shares.[1] The state owns an enormous wealth, but the population is poor. Thus a certain portion (30–40 percent) of so-called "people's" property could be returned to the people as private property. With the appearance of markets in housing, land, and shares, total supply in the market will expand and the value of money will again be reliably supported. In view of the high inflation and bacchanalia of prices, it is very urgent to create some anchor to stabilize the monetary system and the emerging market economy.

A Parallel Currency

A currency parallel to the ruble (chervonets) with solid commodity backing (for example, land, natural resources, and other privatized property available on the open market) and freely convertible into foreign currencies might serve as such an anchor. Unless this is effected, the dollarization of the economy is inevitable, as is a dollar exchange rate that would leave the country open to carpet bagging. The growth in attractiveness of the dollar as a stable currency easily convertible into any goods will whip up the demand for it and, hence, its exchange rate. For this reason, it is better to tackle the problem of creating our own hard currency that will gradually displace the existing one.

A Supply-Side Approach

The weak point of the economic stabilization measures undertaken by the Ryzhkov and Pavlov governments and even those of the present Russian government consists of the fact that the emphasis has been on the fiscal side: the use of taxes to restrict the demand of the population. This restriction undermines the motivation for productive and conscientious labor. The main reserve for healing the economy and its monetary system lies elsewhere: in the growth of production and entrepreneurship. True incentives will appear and then, on the same land and with the same production capacities, we would be able to increase output 1.5 to 2 times. In my opinion, such incentives could be encouraged by two things: stable money and actual ownership of

[1]The voucher program has now been initiated in Russia—ED.

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property, which together would lead to a rise in entrepreneurial initiative and guarantee economic freedom. State revenues should mainly increase through the stimulation and expansion of production, profits, and personal income rather than through comprehensive increases of the tax burden.

An Independent Monetary System

Of course, we must question the feasibility of overcoming hyperinflation and restoring a healthy monetary system within the boundaries of the Commonwealth of Independent States (CIS). To succeed, it is at a minimum necessary to ensure such indispensable prerequisites of recovery as the elimination of the budget deficit, strict control over monetary and credit emission, and severe restrictions on the growth of the internal debt of some members of the CIS. To date there are few convincing arguments that such is feasible. One might rather expect that Ukraine and some other CIS members would prefer to create their own national currencies and resent the idea of a unified ruble zone. Russia, for its part, can hardly tackle the problem of ruble stabilization if the ruble zone includes states that are not willing to waive their sovereignty and accept the still somewhat questionable price, credit, taxation, and monetary emission policies imposed by Russia.

It seems more realistic to assume that Russia will form its own independent monetary system, perhaps in cooperation with some other successor states.[2] If Russia succeeds in restoring sound money, the Russian monetary unit may serve as a tender for inter-republic settlements.

The Difficulty of Reform

The road to restoring strong real money will clearly be rocky and difficult. Undoubtedly the most important factor will be to increase the supply of goods and services on the market as a counterweight to the money supply. Since it is unrealistic to expect an expansion of production in the short run, the most available reserve for saturation of the market is privatization of state property.

Another important prerequisite is reducing expenditures and increasing revenues in the state budget. This problem must be solved against the background of a general decline in production and, consequently, tax revenues. The liberalization of prices will obviously reduce the cost of state subsidization of prices for coal, foodstuffs, pharmaceuticals, passenger transport, and residential rents, but at the

[2]In 1993, Russia, Kazakstan, Belarus, Armenia, Azerbaijan, and the middle Asian republics signed an agreement to establish a common ruble zone.

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same time it will force the government to increase salaries of state employees and to raise pensions.

In the race between prices and wages, of course, prices will lead. The additional profit associated with sky rocketing prices tends to be absorbed by the government (to a considerable extent, if not fully) to support the budget. The hope here is that the lag between the growth of prices and personal incomes in favor of the budget will make it possible to reduce the budget deficit and decrease the circulating money supply. The trouble, however, is that tolerance for a further lowering of personal incomes is close to the breaking point, after which one can expect wide-scale popular unrest and demands for higher wages and pensions.

In a word, it is too early to determine how great the increase in state revenues caused by price liberalization will be. In my opinion, it is best to err on the side of caution.

Of course, strict spending limits are necessary across the entire budget, but the greatest effect should come from reductions in military expenditures, large-scale capital construction projects, and agricultural subsidies.

The level of defense spending in the Russian economy is enormously hypertrophied (up to 40–50 percent of all machine building and roughly 20–25 percent of GNP), which will make the process of conversion extremely painful and costly. Sharp reductions in government purchases of military hardware have already begun. Left without contracts, military factories and R&D organizations have been compelled to either shift production to civilian needs or lay off personnel. Both options require additional expenditures for retooling and unemployment benefits. For this reason there will be no immediate peace dividend. This will only come after a significant lag time. The same applies to troop reductions. These will in all likelihood require several years and will result in the formation of a relatively small professional army. Maintenance costs will be higher for the latter than for a conventional army of comparative size. In other words no large-scale reduction in expenditures should be expected for this item of the military budget.

The Russian government can cut budgetary outlays for capital construction (including housing), provided that big banks will take over this function. But the latter are very reluctant to do so, given their limited resources. As regards the repeal of the bulk of state agricultural subsidies, this is quite realistic with the introduction of free prices. Producers will recoup their losses through price increases provided consumers have enough money to buy foodstuffs, which is unfortunately not the case.

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In view of relatively limited reserves for reducing budgetary expenditures, greater hopes are placed now on increasing tax revenues. Because of the decline in production and its ever-decreasing profitability, the budget is deprived of considerable income. Through tax reform the government intends to increase the burden laid on the population and enterprises. In comparison with the leading countries of the West, higher rates are envisioned for income taxes, profit taxes, and value-added taxes. All this, unfortunately, has a dampening effect on the economy, suppresses entrepreneurial and labor activeness, and any desire to earn more. No reasonable compromise between the desire to increase revenues through taxation and the need to encourage economic activity by easing the tax burden has yet been found. In the final analysis, the most optimal variant would be growth in tax revenues as a result of an expansion of production.

Finally, the government of Russia is counting on augmenting the budget through the sale of property at its disposal that was previously declared to be the property of the people. It is very difficult to estimate potential revenues here, not only because of the absence of a real market evaluation of the worth of state property, but also because of the uncertain mechanics of privatization itself. At present it is spontaneous and uneven and accompanied by the expropriation of the state property by lower-level authorities or economic organs. This adds virtually nothing to replenishment of the state treasury. On the other hand, the employees of the state enterprises are showing an interest in buy-out options.

However, this is only possible on borrowed resources, since all residual personal savings have been consumed by the price liberalization. In short, the state must provide credits initially and then only after several years anticipate repayment. Considering hyperinflation, these payments will actually amount to virtually nothing. Moreover, the absence of real market assessments on state production assets means that the transaction itself is frequently completed at prices so low as to make them merely symbolic.

Presumably "small" privatization (the sale of small and medium-sized shops, restaurants, and other outlets) will enable the state to absorb the amassed cash resources (acquired legally or illegally) of the growing stratum of entrepreneurs and trade mafia. This might be several dozen billion rubles. The devaluating money can be profitably converted into real estate. However, on the other hand, it is obvious that the new Russian authorities at all levels show great hesitation in the privatization of state property, since they understand that with its sale or distribution their power is destroyed. This is especially true on the question of land, natural resources, and large-scale industrial

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enterprises. Very little is being done to assess the real value of the property to be privatized. Serious efforts in this direction are taken only in the event of a partial sale to foreign investors. There is no competent administration at the different levels capable of taking on privatization. The bodies formed for this purpose do not have any property at their disposal, and must privatize the property of others.

Western capital also displays caution in the acquisition of enterprises. It is frightened away most of all by political instability, the lack of a normal market environment, and the bureaucratism of the authorities.

In principle, it is precisely a rational and socially just privatization of the enormous wealth that the state possesses that is the key to recovery of the monetary system and transition to a healthy market. Unfortunately, currently there is not the required decisiveness, clear conceptualization, or administrative mechanisms to make privatization an effective tool for stabilizing state finances or for ensuring the stability and internal convertibility of money. For this reason, during the coming year privatization will have a relatively modest role in fighting inflation and in the creation of a sound currency.

The Role of the West

Up to now foreign loans have been used as a life preserver for the floundering economies of Russia, Ukraine, Kazakstan, and the other states that have emerged on the ruins of the former Soviet Union. The transition to a market economy will undoubtedly be made easier by debt rescheduling and the provision of new credits. But today nobody harbors any illusions that the inflow of money from outside, even uncompensated aid, can be the main factor in financial stabilization and in the market transformation of Russia. The West does not command such resources and does not want to take the risk in view of the instability in Russia.

It is difficult to foresee the granting of large credits to Russia during the coming years for the purpose of balancing its current international accounts. The inflow of credit will be directed to projects in very specific areas with the greatest potential for stabilizing the Russian economy and repaying debts.

The next few years will bring major outlays for servicing outstanding debt. At an artificially low market rate of exchange for the ruble, the purchases of hard currency for these purposes by the state from Russian exporters will lay a heavy burden on the budget. As regards the obligatory sale of 40–50 percent of export revenue to the state at its artificially low exchange rate, this source of hard currency revenues is becoming ever less reliable. It is undermined by the emerging

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market, which encourages exporters to conceal their hard currency incomes.

Despite all these caveats, the West can play an important role in Russia's transition to a market economy and in the stabilization of its monetary system. Of course, this assumes the mutual political will for large-scale economic cooperation. Especially necessary is a resolute orientation on Russia's part toward attracting Western expertise and investments and a rapid creation of the appropriate legal and economic conditions and guarantees.

I would argue that the West should offer major loan assistance in the interests of accelerating military conversion, eliminating a part of our nuclear arms, carrying out a monetary reform, and establishing convertibility of a new currency. Without the formation of an adequate hard currency reserve (spent gold reserves should be restored as soon as possible), the success of the monetary reform cannot be guaranteed.

The rebirth of the Russian economy should be based to a great extent on foreign investments. The USSR artificially isolated itself from the process of transnationalization of production. Multinational companies had no presence on its territory, and the largest Soviet industrial enterprises had no investments abroad. Now Russia must actively integrate into the world economy, open its doors and create all the necessary internal preconditions for the activity of transnational corporations of the leading countries of the West. This presupposes the outright sale of some enterprises to them, or the sale of shares, in some cases even a controlling interest. Concessions to foreign companies in the exploitation of natural resources, transport facilities, and communication lines should also be encouraged. Broad attraction of foreign investment demands guarantees on possible repatriation of capital investment and a reform of mortgage law to allow the use of land plots and real estate as collateral for credit.

It seems to me that the West should tie its assistance in stabilization of the Russian monetary system and in establishing ruble convertibility to the formation of all other favorable preconditions for foreign investment.

Other Prerequisites for Monetary Stability

Among the important prerequisites for healing the Russian monetary system we should mention reform of the credit system, its expansion and technical modernization, as well as bringing rather neglected systems of bookkeeping, accounting, and auditing into order. The activity of the central bank and state and commercial banks should be subject to legislative regulation that would forbid

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offering loans in the absence of reliable means of repayment, various forms of currency and securities speculation, and exceeding permissible limits of liquidity. Monetary emission should also be subject to the rules of banking and not the instructions of the government.

Finally, any credible monetary reform must restore confidence in the state that prints the money and guarantees its solvency. Currently this confidence is undermined by the actions of the government, which has consciously devaluated almost fully the savings of the population and pushed inflation. In order to halt the flight from money and make its accumulation and deposit attractive, it is necessary to not only halt inflation, but to strengthen the authority of the state as a representative and protector of the public interest.

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Russia's Informal Revolution

Paul Craig Roberts

Oleg Bogomolov reports, correctly I think, that the key to a sound monetary system and transition to a market economy is the privatization of the wealth that is in possession of the state. He also reports, again correctly, that prior to price liberalization, property should have been privatized, monopolistic structures demolished, foreign trade liberalized, the budget deficit reduced, and the money supply controlled.

He then reports, again correctly, that there was no time to do these things, no effective executive authority to carry them out, that numerous prices became free de facto in advance of official reform policies, and that privatization is also following a de facto course in which state property is simply seized by authorities and lower-level economic bodies. The kind of privatization that Bogomolov recommends, and that I also favor—consisting of large-scale gifts to the people of apartments, land, and shares in enterprises converted to joint stock companies, as partial compensation for the enormous material losses of the population—is blocked by the restraint of the Russian government at all levels, because those in control of government understand that the sale or distribution of state property among the population diminishes their power.

The Case for Optimism

Faced with the facts reported by Bogomolov, we can become pessimistic or optimistic. Let me make the case for optimism. The transition to capitalism in Russia is too big a problem for politics. Informal social processes will lead the transformation, and official state-led reforms will lag. Considering the weakness of the government, there is a good chance that its role will be to follow along

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afterward, giving its sanction to most of the transformation and overturning only those parts that are most strikingly unfair. This means a lot of turmoil and many false crises along with some real ones while things sort themselves out.

Another reason for optimism is that Russian economics, as practiced by Bogomolov, is a great improvement over the old Soviet economics. Bogomolov's analysis embodies the role of expectations in inflation and hyperinflation. Unlike some of the Western advisers to the Soviet and Russian governments, he understands that so-called stabilization measures directed at the "ruble overhang" merely restricted the effective demand of the population and wiped out its savings, thus undermining the motivation for productive and conscientious work and financing for entrepreneurs. He understands, better than the bureaucrats in the IMF, the Congressional Joint Committee on Taxation, or the U.S. Treasury, that the tax measures designed to address the Russian budget deficit are a package of disincentives that will suppress the entrepreneurial and labor activities that the economy most desperately needs. He arrives at the supply-side prescription that the most optimal policy for the growth of tax revenues is the expansion of production. Unlike Western development economists, he understands the critical role of foreign investment. Unlike so many of our own professors, he understands that it is necessary to strengthen the authority of the state as a representative and defender of the interests of the population, by which he says he means the provision of sound money and guarantee of economic freedom.

Eliminating the Source of the Inflation

Where then can we criticize this free-thinking Russian? I found two places. He urges a commodity-backed ruble to anchor the monetary system. I do not object to a commodity-backed currency. Rather, the problem with the ruble is that too many are being printed in order to finance state deficits. As long as there are state deficits that must be financed with money creation, a new currency would be subject to the same inflation—commodity-backed or not. The design of a new currency is a big challenge that would divert effort, perhaps without effect. It would be better to privatize and, thereby, eliminate the state deficits that are the source of the inflation.

Bogomolov recommends that the West back a new Russian currency, and he suggests that the West tie its assistance in stabilizing the Russian monetary system and ruble convertibility to an opening of Russia to foreign investors. Again, a currency cannot be stabilized if it has to be printed in great quantities. Moreover, tying foreign aid to foreign investment could be politically risky for a weak government

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with a nationalistic opposition, who could then accuse the government of selling out the country to foreigners.

In fairness to Bogomolov, he came up with these proposals because he sees inaction in large-scale de jure privatization and settled on strengthening the ruble as the only feasible plan. There is no doubt that Russia and the other republics face enormous challenges. But we should remember that these peoples or their ancestors survived Lenin, Stalin, forced collectivization, state-inflicted famine on more than one occasion, World War II, paranoid leadership, and 75 years of the worst economy the world has ever seen. With all this under their belts, I think they can survive the transition to private property and a market system. However threatening a free-price system might seem to some, it is nothing compared to the gulag.

Informal Processes of Transition

We should keep in mind that there is a great difference between the official reform model and the informal processes of transition. The Russian government may, or may not, be following the Polish model, but the informal privatizations, evolution of de facto private property rights, day-to-day transaction prices, and so forth are moving on their own paths. In a sense Russia is a wide-open frontier society. People who have the confidence to act are acquiring rights by exercising them. Bogomolov reports that the central government lacks power and that its policies are wrong, and he sees this as a problem. But it might be an advantage. If the policies are wrong, it is just as well that the government lacks the power to implement them.

We have heard a variety of complaints, which paint a hopeless picture but look less disturbing when put in context. For example, the Russian budget deficit is said to be 14 percent of GNP, which puts it in the same league as the Italian one, and Italy remains a pleasant and entertaining place to live. Russian monetary policy is said to be impaired because the ruble is supplied to most of the former Soviet republics. However, the dollar is supplied to the whole world, and the United States enjoys corresponding reserve currency privileges. Official statistics show collapsing Russian GNP, but these data do not measure the unofficial economy or the more efficient use of resources as they are shifted from meeting gross output targets to real needs. The monetary situation is deplorable, but South American countries have lived with higher rates of inflation for longer periods of time, and even demoralized POWs fashioned a monetary instrument out of cigarettes to facilitate trade. Russia will do no less.

Even in its heyday, the Soviet economy never worked. People learned long ago from necessity how to get around it, and a large

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percentage of the resources has always been allocated unofficially. This unofficial economy is the basis for the new economy, and it is misleading to see the decline in official production as collapse if unofficial production is growing.

Avoiding a New Bureaucratic Class

In our efforts to aid Russia and the other republics, we should be careful not to empower a new bureaucratic class that would create incentives that would divert entrepreneurs away from profit-seeking into rent-seeking activity. The history of our foreign aid to the Third World is largely one of subsidizing the rent-seeking behavior patterns of the mercantilistic economy. It would be better not to help the Russians at all than to underwrite a rent-seeking system.

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Monetary Stabilization in Russia: What Is to Be Done?

Nikolai Petrakov

Unfulfilled Expectations for the First Steps of Russian Reform

After the prolonged stalling of the Nikolai Ryzhkov government and Valentin Pavlov's half-hearted reforms, Boris Yeltsin decided to bet on the "tough boys" of the Yegor Gaidar team. The Gaidar reform plan attempted to copy, as precisely as possible, the Polish shock therapy option. Price deregulation was seen as the key to the elimination of the budget deficit, to monetary stabilization and ruble convertibility, and to the structural reform of the economy—not just a key anymore but a sort of magical "Open Sesame" for every lock on economic progress.

It became increasingly clear that the calculations of the young Russian theorist-reformers were not proving accurate for two reasons.

First, the price hike turned out to be far steeper than Deputy Prime Minister Gaidar supposed. He expected prices to increase by 2.5 or 3 times in January and February 1992. Yet typically, in the first month prices increased tenfold.

Second, the Russian government believed that following the price increases, the supply of goods would increase drastically and store shelves would be filled. These hopes were based on the following. The government had announced the price liberalization two months in advance and expected producers and traders to stock up on goods. In addition, there were hopes that business activity would be quickly energized in all spheres, and also that demand would fall with the decline of purchasing power.

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Only the latter came true. The purchasing power of a significant portion of the population fell drastically, and living standards took a nosedive. By the time reform entered its second month, the per capita monthly income for the bulk of Russia's population (96.2 million people of the 148 million residing in the Russian Federation), including all additional benefits announced and introduced prior to price liberalization, was 400 to 650 rubles. By then, however, the cost of basic subsistence had gone up to 920 rubles a month.

Leaving over two-thirds of the population under the poverty line, the Russian government was still unable to balance the market. Is this a paradox? No. Making a fetish of the Polish experience, the young reformers did not take into consideration the actual situation in their country and the specifics that set it apart even from Slavic and formerly socialist Poland.

Only unbelievable economic myopia can explain their decision to ignore at least three basic differences between pre-reform Poland and Russia.

First, Poland always had a powerful private sector embracing virtually all of agriculture as well as small business and services. That is why price liberalization in that country became an effective stimulus for the rapid growth of business activity in that sector, helping saturate the market.

Second, the Polish economy never had to contend with such a monster as the military-industrial complex. Russia's military-industrial complex not merely consumes a tremendous amount of natural and human resources but demands special centralized efforts and, most importantly, time for reorientation toward market forms of economic activity. Liberalizing prices and giving wide latitude to the enterprises of this complex are obviously a dead end, creating a potentially explosive situation in the very first stages of market reform. The more the government cuts investment in the military-industrial complex, the more it has to be involved in the processes of conversion to civilian production, altering the distribution channels for military products, and securing social guarantees for the workers.

Third, for at least two decades, Poland lived with the very dollarization our reformers so dread. This was a result of many factors, including the more liberal face of Polish socialism. The important thing is that the Balcerowicz reforms to strengthen the zloty were carried out amidst the fairly wide and legal circulation of foreign currency. It seems that this point is being completely ignored in the approach to the tactical tasks of stabilizing the consumer market in Russia.

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The objective impossibility of carrying out the Polish reform option, combined with a passionate subjective desire to do so, led to a striking but logical result: the creation of the very situation that Gaidar's predecessor, Valentin Pavlov, wanted to bring about. Putting the privatization of state property on the back burner, Gaidar reduced price liberalization to a legal state monopoly on price setting. The heads of state-owned, cooperative, and private enterprises, traders, and the public—everyone understands that if state monopoly remains (and, in fact, the state sector accounts for 92 percent of manufacturing, 85 percent of agriculture, and 99 percent of transportation), prices will only continue to grow. If there is no competition, there is no incentive for the reduction or at least the stabilization of prices.

The government obviously underrated the degree to which the Russian economy is dominated by monopolies. Today, only rapid privatization and demonopolization of industry, agrarian reform based on private ownership of land, and a liberalized tax legislation can save reform.

But there is another, no less important issue: monetary policy. No market reform is possible if the government and the central bank cannot inspire confidence in the national currency. Unfortunately, even as the Russian government has to carry out its program, it lacks control over the processes affecting the monetary cycle. Attempts to balance the budget run into problems that are unsolvable in the short term. The two main problems are (1) social programs, which the Russian parliament and the labor unions want implemented; and (2) the financing of the military-industrial complex. The government has been very firm in dealing with the latter. Investment in the military sector has been virtually cut off, and state contracts for purchases of military technology have been reduced to a minimum. There still remains, however, the problem of paying salaries or unemployment benefits to millions of workers in the military-industrial complex. In the months to come, the government will not be able to wave aside this issue, and therefore will yet again have to resort to printing more money.

The formulation of a rational monetary policy runs into yet another serious obstacle that the current Russian government pointedly ignored in the preliminary work on the reform program and in the first stages of its implementation. The new states that have taken the place of the USSR are unwilling to cooperate with Russia in stabilizing the ruble. This is evident not only in the position of Ukraine, which is, in essence, actively pursuing a separate monetary

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reform, but also in the actions of the Baltic republics, Belarus, and Tatarstan, which are imposing various restrictions on the use of the ruble as a common currency unit.

One of the hottest topics of discussion in the Russian parliament, in political circles, and in the media right now is how long the present Russian government will last. It is difficult to answer this question. Much depends on the stance of Russian President Boris Yeltsin. But even he is forced to maneuver in this complicated situation. Naturally, these maneuvers will take place in the upper echelon of power, since the government's current policies do not have a constituency in any specific segment of society. Inflation alienates the intelligentsia, since scholars, doctors, teachers, and college instructors were the first to feel the blow of price hikes, offset by no increases in income. Entrepreneurs complain about the tax burden. Peasants see no real progress in agrarian reform. Workers believe that the only way to influence the government is to threaten a strike. Thus the government has no firm social base of support. To stay in power, it must answer the question: For whose benefit is it conducting reform?

An Analysis of the State of the Russian Economy

The uniqueness of the old Soviet economy, in addition to the already noted centralization and the hypertrophied state sector, was also in an entirely original manifestation of inflation. The Soviet form of inflation (also observed, for that matter, in the USSR's satellite countries) was labeled as "hidden" or "suppressed," which yet again attests to the power of the Bolshevist political doctrine that extended its characteristics to spheres adjacent to politics (the economy, culture, etc.). According to the data for the years preceding Mikhail Gorbachev's emergence in the political arena (1971–85), the cash supply increased 3.1 times, while the amount of money in the population's savings accounts increased by 5.2. In the same period, however, the production of consumer goods only doubled. According to a number of experts who worked at the time at the USSR State Bank and at the USSR Ministry of Finance, in 1968 the USSR State Bank adopted the clandestine practice of extending credits, with no obligation of repayment, to the USSR Ministry of Finance. By 1985, the state budget deficit had reached 18 to 20 billion rubles.

Gorbachev, assuming power in April 1985, was facing the complex problem of strengthening the economy. The economic crisis was reflected in the budget deficit, concealed from the Soviet public but known to Gorbachev, and in the hypertrophied export of raw materials at the same time that oil production and world-market oil prices began to drop. The last circumstance played an especially

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crucial role, since profits from oil sales were the Soviets' main source of funds for purchases of grain and many food products. It was by this irrational method that the myth of the viability of collective agriculture, and socialism as such, was sustained.

For a long time, however, Gorbachev's reformism left the economy untouched. It is now clear to everyone that Gorbachev's domestic political reforms (leaving aside his truly great accomplishments in international policies) turned out to be a colossus with feet of clay. The constant fear of a political backlash, the inordinate swelling of the political ambitions of regional authorities—all of this resulted from the absence of a strong social segment of private property owners. Gorbachev was not ready for the creation of such a social segment. That is why his legacy to the country's leadership was an economic crisis and political chaos.

Let us return, however, to the monetary system as an indicator of the progression of the economic crisis.

The ominous escalation of the money supply started in 1988, when Ryzhkov launched his so-called market reforms. His first step was not to sell off state properties or to cut the military-industrial complex but to print more money. This was despite the fact that the successes of the policy of "new thinking" proclaimed by Gorbachev in the international arena had created all the conditions needed for the conversion of industries to civilian needs. Ryzhkov, however, represented nothing other than the military-industrial complex itself, which viewed global détente as a breather in the arms race and an opportunity to get Western credits for the purchase of technologies that the Soviet industrial system, deprived of entrepreneurial incentive, was no longer able to create.

And then, the "snowballing effect" emerged: the cash supply increased by 13.6 percent in 1988, by 19.5 percent in 1989, and by 24.3 percent in 1990. And finally, in 1991, the efforts of Pavlov and the democrats who came to power in August resulted in a virtual doubling of the cash supply.

This money-printing orgy took place amidst a sharp drop in production. The net national product declined by 11 percent in 1991. There was a similar drop in oil and coal output. Production of synthetic fibers fell by 22 percent, timber production by 14 percent, and production of celluloid by 21 percent. But what had the most drastic effect on the consumer market was the 10 to 15 percent drop in production in light industry and the food industry.

Not surprisingly, this aggravated the Soviet economy's permanent imbalance between the population's cash income and consumer spending. In 1991, the gap between the population's income and

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spending reaches 24 percent (about 300 billion rubles), up from 12 percent in 1990. The total cash income of the population was estimated at 1,250 billion rubles in late 1991, that is, 1.9 times the 1990 amount.

Such an imbalance was found not only in the consumer sector and not only in cash circulation. Serious disruptions in the monetary cycle were taking place across the board in the national economy. The cash circulation makes up only 15 percent of the total circulation of money. Along with the emission of cash, there is also non-cash credit emission, which actually determines the general state of the monetary system including its cash component. The total money supply (cash and non-cash) reached 18 trillion rubles by the end of 1991.

In describing the overall state of the economy on the eve of the Russian government's reforms, one must also consider the size of the budget deficit. By the government's own calculations, Russia's actual budget deficit stood at 108.4 billion rubles in 1991. Here, it must be noted that when the annual budget was approved by the Supreme Soviet of the Russian Federation, its revenues were set at 149.8 billion rubles. However, as a result of the events of August 1991, Russia ultimately had to take on a number of functions formerly performed by the leadership of the USSR. This had a considerable impact on the structure and the size of the revenues and expenditures in the Russian budget. For all intents and purposes, the Russian budget assumed virtually all the expenditures of the former USSR. Of course, it also took over the Soviet budget revenues; but it was a Pyrrhic victory.

Russia's Actions to Restore Monetary and Financial Health

The main goal the Gaidar government sought to achieve was a drastic reduction of the budget deficit. This problem was addressed in four principal ways.

The first, which was not disputed by anyone in the country, was to reduce administrative expenditures. However, in a purely numerical sense, the reductions had no real impact. Even if expenditures on the entire government staff were cut in half, the total amount of budget spending would be reduced by no more than 1.5 percent.

That is why the government chose as its main approach to the reduction of budget expenditures the second path: a drastic cut in military spending. This is undoubtedly right, given the hypermilitarization of the economy of the former USSR. Naturally, the bulk of military expenditures both on the maintenance of the armed forces and on the development and production of weapons was always borne by Russia.

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It is worth nothing that the choice of this approach as the key to deficit reduction is proof of Yeltsin's courage, since a large and influential portion of Russian society has a stake in the military-industrial complex. Here, the interests of the army, of heavy industry, of many branches of science, and of a substantial proportion of highly skilled workers and engineers meet. The decision to make radical reductions in the budget financing of the military-industrial complex is a bold and historic choice on Yeltsin's part. It is a step Gorbachev did not have the nerve to take. He faltered and had to leave the political arena. Yeltsin did not falter. But whether he will be able to defeat the monster in open combat is something the near future will show. At any rate, in order to defy the military-industrial complex, Yeltsin had to begin by dismantling the Soviet empire politically and thus demoralized the army.

Of course, sharp reductions in defense contracts pose the risk that entire enterprises will grind to a halt, causing mass unemployment. Moreover, the paradox of our militarized economy is that in the transition to the market, the best-skilled workers and engineers will be the first to lose their jobs, since they are most highly concentrated in the defense sector of industry.

The third path of reducing the budget deficit is tax reform. The principal form of taxation introduced into the national economy in January 1992 was the value-added tax. The VAT rate has been set at 28 percent. In addition, the government has decided to tax profits at 32 percent. Exempted from this tax are profits reinvested in social and cultural development, the expansion of production for consumer needs, and environmental conservation measures.

We thus have a rather exotic combination of two kinds of taxation; moreover, the profits tax is levied even on profits that are reinvested in the economy, unless the investment is directly related to the production of consumer goods.

The combination of the two tax rates and their respective levels—28 and 32 percent—creates an extremely heavy tax burden on producers. In the effort to suppress inflation, government officials are discouraging economic activity through high taxes, and thereby creating no incentives for growth in the supply of goods and services. This generates a vicious cycle: measures to slash demand by reducing purchasing power lead to a reduction in the supply of goods.

The government has profound faith in the fourth lever of balancing the budget and stabilizing the monetary cycle: the liberalization of prices. As noted at the beginning of this paper, it was precisely in this area that the government has created a critical situation. Price liberalization unsupported by privatization of property and demonopolization

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has aggravated social tensions far more severely than the resolute attack on the military-industrial complex. But while the problems arising on the "military-industrial flank" of the frontlines of reform were inevitable and easy to forecast, the weakness of the pricing policy flank has been almost completely the fault of the reformers themselves: the plan and sequence of actions that they selected were far from the best. Underestimating the degree of monopolization in the state-sector industrial structures has led to monopoly-generated high prices and a simultaneous drop in production to a level at which high prices can be maintained. This leads to three consequences: a decline of budget revenues; a sharp drop in the living standards of the population, and, for the government, an explosive social situation and the impossibility of keeping the budget deficit under control.

What Is to Be Done?

First of all, we must presume that a continuation of the government's current program without corrections along the way dooms the country to hyperinflation. In order to avoid it, strong medicine is needed. Of course, it is necessary to alter tax policies, making all profits that go toward reinvestment tax-exempt.

Furthermore, a land market, a housing market, and markets for other kinds of real estate must be created immediately. Speedier privatization of industry and trade is necessary, as is radical agrarian reform that would end the monopoly of collective farms and state farms.

Undoubtedly, legislation regulating foreign trade and foreign investment must be changed to conform to international standards, creating firm political and judicial guarantees for foreign investors.

But for these steps to have the desired effect, the Russian government must define the geographic and political space in which the reforms will be implemented.

The fact is that the entire package of economic agreements among members of the Commonwealth of Independent States (CIS), achieved in December 1991, was completely disavowed as early as January 1992. Among the agreements that were shelved was the accord on the nonintroduction of republican currencies until the end of 1992. Yet the Baltic states, which are not a part of the Commonwealth, abided by this principle for a longer time than one of the CIS co-founders, Ukraine.

The fast disintegration of the ruble zone will be encouraged by two factors. First, there are the political ambitions of the new countries' leaders. A currency of one's own is regarded by them as a ritual

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symbol of sovereignty, in the same way as an anthem, a state seal, and a flag.

Second and most importantly, the monetary system is undermined by the hyperinflationary project of market reform adopted by the Russian government. The problem is exacerbated by the fact that, having eliminated the USSR State Bank, the founders of the CIS have not made any decision to create either a central CIS bank or an interstate banking union. This has led to a legal and economic absurdity: Russia is supplying 14 independent states with its own currency. This situation is pregnant with a conflict that can only lead to an economic war. And we already witnessing just that. The Russian leadership has sentenced the Soviet ruble to death.

What could be proposed to stabilize the monetary system within the framework of a ruble zone?

It is now realistic to speak of the creation of an interconnected network of national currencies. I am not excluding the possibility that two or three republics can agree on a common currency; but that is not going to change the whole picture. The most important thing is to concentrate on developing a joint monetary policy. There is a danger that the new states that have emerged from the ruins of the USSR will follow the pernicious course of the former COMECON. The creation of national currencies will be divorced from resolving the problem of their convertibility, that is to say, their integration into the international monetary system. This task has two aspects: the monetary system must contribute to the preservation (or recreation) of a common economic space and, at the same time, encourage integration into the world market.

Given the current political situation, Russia can play a leading role in the stabilization of the monetary system. But even Russia, faced with a 15–20 percent drop in production and unfavorable conditions in the global oil, gas, and gold markets, is unlikely to be able to handle this task without support from the world community. The ideal option would be an international project to organize a monetary system in Eastern Europe. Before the process has started to develop spontaneously, a currency chain of mutual convertibility on the basis of the new Russian ruble can be created. The economic attractiveness of the Eastern Currency Union would be a powerful boost to political stabilization in the territory of the former Soviet empire.

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What Went Wrong?

Judy Shelton

Nikolai Petrakov has given us an informed critique of the "shock therapy" approach to Russian economic reform implemented under Deputy Prime Minister Yegor Gaidar. In Petrakov's opinion, the decision to emulate the Polish model was a mistake; he contends that Russia's lack of a private sector and the huge scale of its military-industrial complex render it incapable of achieving a market economy merely through the liberalization of prices.

Lest anyone be tempted to categorize Petrakov among those political hardliners in Russia today who are opposed to free markets and democratic reform in general, it is important to point out that Petrakov chose to resign his post as Gorbachev's chief economic adviser in January 1991 rather than continue to serve a government that sought to undermine genuine economic reform and used military repression against Lithuania. Petrakov was particularly critical of the Soviet leadership at the time for losing control over spending and the money supply; he believed its actions effectively sabotaged the transition to a market economy.

Rhetoric versus Reality

When Petrakov aims his ire at Gaidar and company, rest assured he is not concerned with personalities but with principles. Petrakov's most stinging criticism of the Gaidar program is that prices were "freed" in the absence of meaningful competition. "Putting the privatization of state property on the back burner," he notes, "Gaidar reduced price liberalization to a legal state monopoly on price setting." That statement is consistent with remarks made by Petrakov to the press at the beginning of 1991 when he complained: "Prices set by the

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Government are pseudo-prices. They don't equalize supply and demand, and there aren't any goods anyway. It's a fake."[1]

If Petrakov is correct in pointing out that today's higher prices in Russia do not reflect the natural interplay of supply and demand among competing producers and purchasers but instead represent a license granted to state-controlled monopolies to overcharge, then the reforms cannot be expected to bring about increased supplies of goods. Petrakov notes that the state sector still accounts for the bulk of manufacturing, agriculture, and transportation—and without real competition, he asserts, there is little incentive to reduce or to stabilize prices.

Petrakov's insights help us to better appreciate the gap between the vision of Russia's economic future proffered by Gaidar and the more likely outcome engendered by the shock therapy reforms. What are the chances that the Russian domestic budget will actually turn out to be balanced? Petrakov applauds the reduction of expenditures in the military-industrial complex, but voices concern about having to pay salaries or unemployment benefits to the millions of workers who will be displaced. He notes that the government will not be able to wave aside the need to raise the level of spending for the social safety net. He asserts, too, that the conversion of military factories to civilian use will require additional funds over and above the amounts the government hopes to raise by selling off military equipment to other countries (with all the disturbing implications that carries for global security).

The Danger of Hyperinflation

Petrakov chastises the reformers for not recognizing the need to create either a central bank for the Commonwealth of Independent States (CIS) or an interstate banking union to control the money supply in the post-Soviet regime. But even if Russian central bank officials were to quit printing rubles tomorrow, the effect on the overall money supply would be minimal, because, as Petrakov notes, cash circulation makes up only 15 percent of the total circulation of money. Non-cash credit emission actually dictates the size of the money supply, and according to Petrakov's assessment, that figure has been snowballing since 1988. Add to past monetary sins the fact that rubles from Ukraine and elsewhere will be returning to Russia as they are superseded by individual national currencies, and one can appreciate Petrakov's fear that his countrymen are doomed to hyperinflation.

[1]Quoted in Whitney (1991).

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Though Petrakov does not explicitly say so, the evidence he presents on the growth in the cash supply makes it even more difficult to accept the sudden rise in demand for the ruble as having occurred as the result of any natural market process. Increasing the already swollen supply of rubles are the ruble-denominated loans being issued by the 1,200 commercial banks now operating in Russia. According to Louis Uchitelle (1992), commercial banks borrow money from the central bank, or from uninsured depositors, and then lend the money to business enterprises at a much higher rate—but at a rate far below the rate of inflation. This irrational banking scheme is perpetuated by continually postponing repayment and thus "avoiding a showdown over whether the borrowers will pay off their debts or default on the loans" (Uchitelle 1992).

An Agenda for Real Reform

We should be grateful to Petrakov for confirming what a small, but insistent, cadre of Western observers has long proclaimed: That the USSR State Bank was secretly issuing credits to the USSR Ministry of Finance to camouflage a growing budget deficit; that Gorbachev knew about the deficit but kept its existence concealed from the Soviet public and the West; and that high-level Soviet officials such as Nikolai Ryzhkov viewed global détente as (in Petrakov's words) "a breather in the arms race and an opportunity to get Western credits for the purchase of technologies that the Soviet industrial system, deprived of entrepreneurial incentive, was no longer able to create." Petrakov cites Gorbachev's lack of nerve at a critical time as the primary reason for his country's economic crisis and political chaos.

But Petrakov has some constructive suggestions to make as well. We should take to heart his prescriptions for putting Russia on the proper path to free markets and democracy. Specifically, Petrakov calls for speedier privatization of industry and trade, radical agrarian reform, the creation of housing and real estate markets, and new legislation to bring the rules on foreign investment into conformance with international standards. Petrakov also decrees that all profits that go toward reinvestment should be tax-exempt.

For these steps to work, though, Petrakov notes there must be confidence in the national currency. He observes that since some CIS members are intent on issuing their own money, it now makes sense to discuss how to establish an interconnected network of national currencies. This new structure should be simultaneously aimed at (1) creating a unified monetary system across former Soviet republics and (2) facilitating integration into the global economy. Petrakov rightly claims that Russia can play a leading role in the stabilization of such

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a system and he calls for international support to organize new monetary arrangements for Eastern Europe based on a convertible Russian (versus Soviet) ruble.

It is curious that Petrakov never mentions any role for the IMF in stabilizing the ruble. Curious and perhaps significant. Petrakov seems to put more store in the concept of an Eastern Currency Union than an IMF-administered ruble stabilization fund. Maybe we should, too.

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A Market Approach to Monetary Perestroika

Pedro Schwartz

Solving Russia's Monetary Crisis

Adam and Eve must be blamed for the fact that we live in a world of third bests, and that we economists can at most aspire to recommend some second-best reforms. In this paper I defend a fixed exchange rate for Russia, even though I have ever maintained that I wanted flexible exchange rates for Spain, rather than see the peseta join the European Monetary System (EMS); and that I wished the British had kept the pound sterling flexible rather than have it tied to the Deutsche mark within the self-same EMS; and that I lamented seeing the Chileans under Pinochet peg their currency on the Carter dollar. My only discipline in this imperfect world is to keep reminding myself of the unattainable first best, so that the solutions I propose tend to lead to it. This is what I want to do when I turn my attention to Russia.

As Allan Meltzer (1993, p. 709) has said, "We know that fixed exchange rates are not an optimal arrangement under all circumstances or for all countries." The problems of fixed exchange rates were discovered under the gold standard and led many distinguished economists, including Alfred Marshall, to propose some symmetallic money, whereby the value of the currency was anchored but had built-in shock absorbers.

Though the early 19th century currency school did not foresee it, it turned out to be the case that money is pro-cyclical, in that quasi-money and money substitutes overexpand in a boom and overcontract in a slump. These whiplash movements are more exaggerated the further away from the financial center a country is,

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because information about the cycle arrives late and is distorted. If prices and wages are not fully flexible, the real economy suffers sub-optimal gyrations. That is why central bankers in the European Community (EC) are always going on about wages, though the level at which they want them fixed is sure to be wrong.

Also if there is to be a fixed exchange regime, what one ties the currency to is crucial: inflationary or deflationary shocks to the standard, and changes in the terms of trade, may affect the local economy harshly. Also, what is to be done in the case of a bank panic? Allow people to run on the banks to make use of the convertibility promise?

Finally, another problem arises under a fixed exchange rate. If the pegged currency is issued by the government, either the government balances its books sufficiently, or nobody will believe that it has forever renounced collecting the inflation tax. This question of who issues the currency is a separate one, and in fact is not a problem but a part of my solution.

Obviously, whatever the monetary regime proposed for Russia, it will not be perfect and one cannot assume it will be definitive. Let me put this in another way. The monetary regime proposed for Russia for the transition must be compatible with something nearer an optimal currency system in the long term. That is why I am going to propose a *modified* fixed exchange rate regime in Russia, because by starting with this modified system based on a non-monopolistic currency board, Russia could in the end find itself with a full-blown system of nearly self-stabilizing currency and banking competition—and by then the currency board might have withered away.

Having said all this, let me admit that money matters are very complicated and abstract. So I will try to simplify things a bit by first conveying a story I heard on the World Service of the BBC and then using the story to summarize the key monetary problems facing Russia during the transition period.

The BBC reporter had taken a Russian friend to one of the fast-food American restaurants on Red Square (if it is still called that). The friend, an ex-army officer, wistfully remarked that the hamburgers they were consuming cost as much as his car outside, which he had bought with his retirement compensation. For the benefit of his listeners, the journalist remarked that, though the ruble had lately revalued on the black market "for technical reasons," the undervaluation of the currency was destructive of the social bond. The stabilization of the ruble was overdue, he concluded, and it was urgent that the West arrange the loan of a large stabilization fund to defend a fixed parity.

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The anecdote is revealing, in that it condenses the effects of a variety of problems:

1. The relative barter prices of goods and services in Russia are out of kilter. The law of one price does not hold because of restrictions and transaction costs imposed by administrative fiat, as happened with the car our Russian friend obtained cheaply from the military.
2. Cash for transactions at the current money prices is scarce. This is not unusual in an acute inflation, and especially so when coins are used for small payments, whose metal content suddenly is worth more than its face value; I have seen people pay with postage stamps in Italy.
3. The currency lacks internal convertibility. The hamburgers were being purchased with the journalist's dollars because the queue for the ruble side of the restaurant was much longer than for the hard currency parlor—and a queue is another way of reducing the convertibility and ultimately the value of a currency.
4. The currency lacks smooth external convertibility. Either there are many different exchange rates if the government can prescribe the use of the hard currency for certain transactions, or the relative money prices of goods and services do not correspond to their barter prices. In other words, the purchasing power of the hard currency is random.

On seeing these four problems, the foreign consultant is usually tempted to try to solve them at one blow. Like a central banking Alexander, the expert will want to cut the Gordian knot rather than stop to unravel it. If domestic barter prices have been freed, the consultant will say, why not fix the ruble exchange rate with the dollar, and peg it there with the help of a stabilization fund and a restrictive monetary policy?

Now, this solution encounters three major difficulties in Russia (I will not dwell on the difficulties a similar policy has caused in the newly unified Germany, or what lies in store for the EC when it will run a single currency). First, the other states apart from Russia that formerly belonged in the Soviet Union can run a deficit and de facto force the Russian central bank to monetize it by making a call for ruble shipments (though we know that Ukraine is no longer permitted to do that, since it parted from Russia after the referendum of 1991. Second, the Russian government itself is having grave difficulties balancing its budget, and the act looks increasingly difficult. Third, there is a question whether anybody will believe in the time consistency of the Russian government, whether anybody will expect that the fixed exchange rate eventually chosen will stick. And in front

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of perverse expectations fostered by the budget deficit, a stabilization fund can melt like snow in spring—I can think of better ways to use hard dollars than to give them away to ruble "bears," of which there are a great many on the Russian steppes.

Now comes the point when I can put a question mark on current orthodox proposals to give Russia and all the new republics of the East a sound currency or currencies. The Western-trained economist, especially if working for the IMF, will instinctively aim for a full-blown system of monetary intervention: there should be a Russian central bank able to refuse government calls for loans; the bank should choose the exchange rate for the ruble and make it externally convertible at a fixed rate with the help of a stabilization fund; the bank should also use its interest rates to correct balance-of-payments deficits, by dampening internal demand and attracting foreign capital; and the bank should act as a lender of last resort for the fractional reserve institutions of the second tier, and police the value of their loans.

On hearing this list, it is impossible not to have second thoughts. The Russian central bank may be forbidden to lend to the government, but by conducting open-market operations could it not underpin government bond prices in the secondary market? Who can guess the right fixed exchange rate before unemployment becomes unbearable? Is the stabilization fund supposed to be inexhaustible? Would not interest rates bear a large premium, equivalent to the discounted devaluation? And all this in the paradise of moral hazard.

You can guess from this list, and especially from my second thoughts, that I am skeptical. My skepticism is even greater given the likelihood of real shocks for a country undergoing an upheaval like Russia's, and the difficulty of accommodating those shocks with a single monopolistic currency whose exchange rate to the dollar is fixed. And to add to all this, the whole "central bankers' exercise" is well nigh impossible in Russia due to the government's lack of credibility after more than 70 years of communism and after repeated failure to institute real reform.

Some Misconceptions about Monetary Reform

The question of monetary reform in Russia lies not in deciding which is best between a currency board or a central bank, but which as between a monopoly issue of currency and competition of issue. Moreover, it is bad economics to install a transitional arrangement without regard for the achievement of a long-run steady state. Given the state of the country, it may be much more economical and effective to go the piecemeal way, rather than attempt a wholesale

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solution. Forget about pan-Russian monetary reform, budget balancing, and balance-of-payments stabilizing, and try to set up a non-monopolistic currency board, which could slowly ease itself into the system by the spread of spontaneous acceptance, without the government even noticing what is happening. After all, Archimedes cried for a single fulcrum, and he would move the world; he did not ask for a Hercules to raise it bodily. Monetary reform in Russia does not call for a Napoleon and his *Grande Armée* but for some guerilla tactics.

To introduce this piecemeal way of reforming Russia's monetary system, I will try to dispell three misconceptions that I have spotted in the polemic between free bankers and central bankers.

The first misconception is to think that the proposal to establish a central bank governing a national payments and credit system is quite different from the idea of advocating a currency board. A central bank can be made to function like a currency board, and a currency board can easily drift into becoming a classic central bank (see Dowd 1993).

David Ricardo, in his 1816 work *Proposals for an Economical and Secure Currency,* proposed that the Bank of England be stripped of its issuing powers, and that the note issue be turned over to what in effect was a currency board. There would be a Treasury Note Department, issuing notes automatically on deposit of large ingots of gold, which soon were nicknamed "Ricardos." The scheme was not approved but the great man's intentions were clear. He believed that business cycles were caused by the financial misbehavior of private issuers. He therefore proposed that all rights to private issue should be withdrawn; country banks would become simple deposit and credit institutions; and base money creation was to be nationalized. Ricardo, however, knowing from experience during the suspension of specie payments, that it was dangerous to entrust the government, or even the bank directors, with the power to issue currency without a foolproof check, proposed what in fact was a constitutional rule. This "currency board rule" was not enacted in Ricardo's lifetime, and partial and imperfect free banking continued until the 1844 Bank Act. However, the Bank Act was a posthumous but ephemeral victory for Ricardo.

The 1844 act clearly separated the Discount Department of the Bank of England from the Issue Department, so that the issue of notes could only take place against a delivery of gold, and a withdrawal of gold had to lead to the cancellation of the corresponding notes. Hence, the Bank of England was supposed to function in effect as a currency board. But this currency board arrangement had one crippling defect: it vested the monopoly of issue in the Bank of England, constitutionally constrained though it may have been. When

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the 1865 recession came, the bank asked the government for permission to suspend convertibility temporarily—a perfectly acceptable, indeed recommendable, way to forestall a run on the banks, when the measure is taken in the context of monetary competition. However, if the central banker enjoys a monopoly, then nothing is easier for him than to blame his note-issuing competitors for the crash, assume the mantle of responsibility for conducting an anticyclical policy, and ask for the competitors to be eliminated. Not very much later Walter Bagehot (1873), in his classic *Lombard Street,* though a "free banker" at heart, gave in to the prejudice that there had to be only one monopolist central banker in charge of currency issue, and proceeded to accept and analyze the discretionary powers of the new monetary authority that had thus unwittingly been created.

The second misconception is that a balanced budget is necessary to have a sound currency, or that a sound currency necessarily forces a balanced budget on the government. If I may quote examples from Spanish history, the debts of Emperor Charles V led him to concede the exploitation of Venezuela to his Nüremberg bankers, the Fuggers. His son Philip II so overreached himself that he had to renege on his payments three times during his reign (he always excluded one or two foreign bankers from his bankruptcy, so that he could borrow next time round). But neither Charles V nor his son debased the currency, and the Spanish reals and doubloons reigned supreme as the commercial currency of the world for nearly 100 years. Thus, the answer of these two kings to their budgetary troubles was either payment in kind or rescheduling of the debt, not inflation. Later Habsburg kings, especially Philip IV, the patron of Velázquez, did debase the currency by mixing ever larger amounts of copper into the silver of his reals, an alloy deceitfully called "bullion," or *vellón* in Spanish. But in the last quarter of the 17th century, the son of Philip IV, the half-imbecilic Charles II, reformed the coinage to revalue it and make it sound again, with wondrous effects on the economy.

A clearer example of what I mean by there being no necessary relation between the government deficit and inflation is the plight of the great Spanish liberal minister of finance in 1868–70, Laureano Figuerola. He created the silver peseta and started 75 years of monetary stability. However, on taking office after the 1868 revolution, he found the treasury exhausted, a plight made worse on his being forced to abolish some consumption taxes by his ardent revolutionary mates. He considered the idea of committing suicide, but having thought better of it, leased the Almadén mercury mines to the Rothschilds as a fruit-bearing collateral for a loan. The interest on the loan was high, but the treasury escaped bankruptcy. Of course,

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during the whole of the 19th century there had been and would be repeated and less-reputable attempts to ease the treasury problem by setting up a national bank to which a monopoly would be granted in exchange for an overdraft for the treasury. But Figuerola did not stoop that low and the final and successful creation of the Bank of Spain had to wait until just after his time.

The lesson of all this is that in centuries past the possibility of leasing or selling government assets to reduce the debt, or at least to make new issues of debt by a broken treasury palatable to the public, was ever present in the minds of ministers. That is in fact why Spanish church and municipal lands were privatized in 1835 and 1865, respectively. The lesson for Russia, with its $3 trillion assets just waiting to be privatized or sold, is that there is no need for an inflation tax in this case.

The third misconception is that it is necessary to impose a deep deflation at the time of your monetary reform for the public to believe in the soundness of the new currency and to think that the government will not be time-inconsistent. A crisis of confidence in the new currency would occur only if the currency to be redeemed from bad opinion were the official ruble itself, with its huge circulation and its proven obeisance to treasury needs. But if a new parallel currency were introduced, and its reserves were placed beyond the reach of the government and its issue were put in the hands of a private company, or better, of an international institution such as the IMF or the BIS, then there would be no need to prove its soundness and sincerity by self-flagellation. This parallel currency could start in a small way, be floated against the ruble, and spread slowly and spontaneously with no thought for the *Konjunktur*. After all, in the case of John Maynard Keynes's brainchild, the Archangel-Murmansk *Caisse d'Emission*, the sterling-linked ruble notes of the British Expeditionary Force were accepted because it was expected that they would be true, as in fact turned out to be the case. They were redeemed despite the military rout, because the back-to-back guarantee was sited abroad (see Hanke and Schuler 1991).

The Question of Competition

In my view, a central bank functioning under a strict money-creation rule and a currency board issuing the only legal tender are very much a "second best" because they enjoy the dangerous privilege of a legal, not a natural, monopoly. Money has some of the traits of a natural monopoly, but this is not unlimited in time or space, if the state does not take it over. Even with a starting position of exclusivity, if there are no exchange controls, the monopoly positions of these two

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forms of currency creation are not totally without check or limit. But the removal of the legal monopoly of issue is crucial to make a "first best" attainable. The monopoly restriction having been lifted, the currency board standard will prevail only if people choose it.

Moreover, as Kevin Dowd (1993) has pointed out, the currency board will slowly lose its market share to private bankers that issue competing currencies denominated in the standard of the board. Thus, a full-blown free banking system may come to be. Likewise, when a central bank is one of many and ready to compete freely with other central banks, the residents in its zone will be free to use different currencies for each kind of transaction (Swiss francs for pensions and pesos for bus fare). The competing central bank enjoying the largest custom in the zone will tend to set the rule for money creation, since it must be responding to the wishes of its customers as regards stability and credit-worthiness.

In a way, the non-Russian republics of the CIS have already expressed a wish for not having a currency imposed on them. Like Molière's *Monsieur Prudhomme*, they are speaking garbled free banking prose without knowing it.

The crucial question is not whether we have a currency board or a central bank controlled by a constitutional rule, but whether virtual or actual currency competition is allowed to grow. And by "virtual" I mean new entrants, such as VISA, American Express, or the Bank of Hong Kong and Shanghai, actively considering when to come in and offer their own means of payment. After all, those three institutions are already in the business of supplying quasi-money or even actual bank notes.

The Role of Money

We have not gone deep enough into the reasons for the institutions of currency creation being so hotly disputed as they obviously are. To discover these reasons we need to delve into what money does, into the role money plays in modern societies. And the answers are not all economic.

If people are allowed to chose their preferred currency freely (and it is a big if), then a currency or currencies will appear over time performing the following two economic roles.

First, there will exist a *numéraire* against which to measure the relative prices of the goods and services of the economy and consequently of the world. This *numéraire* will help supply essential information with minimal calculation, but it has to be in the transactors' minds when effecting an exchange. It is in fact a mental construct, which, as Eugene Fama (1982) pointed out, could be a

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mere standard for book entry calculations. Such disembodied accounting standards have often existed: the *maravedí* in Imperial Spain, the *livre tournois* in 17th- and 18th-century France, the *guinea* in Saville Row. But its social dimension demands that it should somehow be institutionally defined, if possible, not by a political authority. The service of defining and maintaining such a *numéraire* will be in nobody's interest unless the definer also issues physical money and reaps a seignorage.

Second, there will be a medium of exchange fully convertible into local and international goods and services (and other international or national competing currencies). This medium of exchange will be anchored to its stable unit of account or *numéraire*, which cannot be varied at will by the authorities—it could be a foreign currency, or a precious mental, or a commodity basket. Because it is anchored, it may freely float against other currencies, even those that are denominated in the same monetary unit. This medium of exchange, if well serviced, can perform both important functions at the same time; that is, serve as a standard and dispense with the need for barter. The importance of such services explains why the currency will not usually be interest bearing for the holder. The issuer will reap the seignorage for this service, that is, the difference between the cost of issuing the interest-free currency and the interest it gets on the riskless bonds forming its 100 percent reserve (or 80 percent as in the Keynes's Archangel *Caisse d'Emission*).

It is traditional to speak of a third function as important, wrongly in my view: the function of the currency as a store of value. Though this function may be material in primitive nonfinancial economies, it will not mainly be performed by the currency, but increasingly by the portfolio-managing banking system, once financial markets develop (see Fama 1982).

Unfortunately, though the people may freely choose their *numéraire*, as they do today in Russia with the U.S. dollar, the medium of exchange can be chosen for them by the government. And when the standard is not stably embodied in the medium, then transaction costs shoot up. "The medium is the message," as Marshall McLuhan would say.

This being so clear, who could be against motherhood and apple pie, or what politician would not side with the angels? But this is not the whole story: there is a political side to currency creation that makes protestations of love for a stable price level sound like hypocrisy. The real role of money for people in government, even if they want to be reelected, is a political role. The currency in the political arena is not an instrument of price policy but an instrument

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of fiscal policy, with two dimensions: the increasing of government income, and the spreading of transfers.

The more familiar part is the role of currency creation in the expansion of government income. The legitimate seignorage, as described when dealing with the economic role of currencies, is expanded to become an inflation tax. Thus the tax base shrinks, so that there is a natural though costly limit to the amount of this surreptitious tax being levied. This is admiringly explained by John Maynard Keynes, with references to the use by Soviet authorities of variable inflation of the sovznak as a turnover tax, with the parallel issue by Lenin of the gold chervonets to avoid demonetizing the economy (Keynes 1923, chap 2, revealingly titled "Public Finance and Changes in the Value of Money").

A less-discussed part of the sinful relation between government and money is revealed by the Maastricht Treaty, which sets a date of January 1998 for monetary union. A single fixed exchange rate for European currencies is equivalent to a single currency, which will give rise to regional imbalances. These "imbalances" are one of the political "advantages" of an issue monopoly imposed over a large zone, because politicians will have a role to play in "correcting" the imbalances. Indeed, an annex to the Maastricht Treaty establishes a "Coherence Fund," whereby the governments of states suffering the same sickness now affecting the ex-DDR will receive transfers—the stuff of politics.

A Parallel Currency for Russia

All this should allow us to frame a realistic proposal for monetary perestoika in Russia. My proposal is to use a freely competing currency board to solve Russia's monetary problem. Such a reform should not be described as experimenting (see Klaus 1993, p. 527), but as using the experimental method. A private currency board should be set up in Russia to issue an anchored currency—but not one that would be legal tender, the official currency of the land, or a reformed version of the ruble. It would be a parallel, freely competing currency seen to have no connection whatever with the government and its budget deficit.

The currency board would not issue the official currency, as in Hong Kong. Rather, the parallel currency could be held to a fixed exchange rate with the dollar to start with, but might very well rehook onto a metal anchor once its credibility was established and the true nature of the dollar discovered. The new currency would float against other currencies, especially against the present paper ruble.

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The currency board could bow out once a system of competing private currencies—with a single unit of account or perhaps with different units of account—was established (see Dowd 1993). If the currency board is as necessarily hidebound as Steve Hanke and Kurt Schuler (1993) have detailed for us—with very few branches, with no services except the exchange of paper for the anchor currency and the anchor for paper, and with little leeway in the investment of its backing reserve—then a fully active but reliable private supplier could displace the board, if the private agency issued visibly sound money. In fact, Kevin Dowd (1993, p. 565) is right in demanding that there should be a "sunset clause" to avoid self perpetuation and the transformation of the board into a central bank.

The attraction of a freely competing currency board is that one need not wait for the Russian budget to be balanced, or stop the other ruble republics from monetizing their debt with Russian money, or hope that people will form the right expectations about Yeltsin's anti-inflationary policy. All those desired ancillary aims could be delayed, because, as the experiment of the chervonets under Lenin tends to show, the parallel currency could still spread. Very possibly the bad practices would wilt in time and the accumulated deficits would be settled with asset sales.

The fund of hard currency needed to start issuing the new currency could be quite small compared with the figures implied by an attempt to rescue the present ruble. Steve Hanke and Kurt Schuler (1993, p. 693) think the new parallel currency could be started with a fund of as little as $4.1 billion. Thus, we might be able to solve the transition problem in a manner that would remove the currency from the clutches of politicians more effectively than by postulating the independence of the central bank or by proposing a constitutional amendment.

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The Ruble Problem: A Competitive Solution

Annelise Anderson

The most critical challenge for the republics of the former Soviet Union and for the Commonwealth of Independent States (CIS) is the creation of a monetary system that will serve economic reform and the transition from socialism and central control to a market economy.

The purpose of this paper is to present the case for competitive currency issue by private banks as the best solution to the current monetary and economic crisis. This objective is at once less demanding than presenting the theoretical case for competition in currency issue as the ideal monetary system for all countries at all times, and at the same time more demanding, because it is a specific policy recommendation about what real people in real trouble should do in their current circumstances; and what they do will matter.

The criterion for evaluating this policy option is whether or not it is the best option for facilitating economic recovery and growth in the next one to five years in the context of the effort to make the transition to a market economy.

The Current Situation

Trade both within and among the republics has broken down because of the absence of acceptable means of exchange. Hyperinflation is partly responsible; the difficulties of making contracts and planning for the future when inflation is high and variable, and of perceiving relative price signals amid overall price increases, are of course a problem. But the heritage of a Leninist banking system is also taking its toll.

Ruble deposits of enterprises are not freely convertible to currency; under central planning, the use of currency was limited primarily to

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the payment of wages. Payment for materials and supplies had to be made by bank transfer. The presidium of the Russian Parliament reinstated these restrictions, which had been breaking down, in late January 1992 (Bush 1992). Writing in mid-1990, while inflation was still in double digits, the authors of the 500-Day Plan noted this lack of "fungibility," commenting that the exchange ratio of deposits for currency was often 3 to 1 (Yavlinsky et al. 1991, p.75). Similar exchange ratios continue to exist for transactions on the new commodity exchanges.

The purpose of the state bank under central planning was not to make and collect commercial loans (or even to control the money supply) but to ratify the orders of the central planners by extending such credit as was consistent with plan fulfillment. Output was delivered to the state and the state in turn supplied inputs; it ran a central barter system. Ministries co-owned the deposits of enterprises.

After the failure of one attempt, initiated in July 1987, to create commercial (but still state-owned) banks by transferring loan assets of the state bank to new banks, in 1990 ministries and state enterprises began to create banks (IMF 1991:2, pp.107–115; Vadilov 1991). These banks are designed to lend to their owners and are not likely to function as independent commercial banks in business for profit; the state bank can make interbank loans to them. Thus the financial system does not yet shift the investment decision from the government to the market. The new cooperatives—many of which have been created within state-owned enterprises—have established a number of cooperative banks. They also lend to their owners, but have a greater potential for competitive operation.

In one of the more bizarre episodes of central banking, as of late 1989 the individual republics had established their own "central" banks, at least some of which added to the supply of rubles by financing the deficits of their respective republican governments. The head of the state bank claimed that the Russian republic was a major offender (Lloyd 1991). It seemed as though the republics were competing to issue rubles as fast as they could before the rubles lost their value.[1] Meanwhile the central government was financing its own deficits by printing rubles.

Whether or not Russia or the CIS has in fact regained control of the creation of rubles, one motive other republics, especially Ukraine, have expressed for issuing their own currencies is to preclude an

[1]Benjamin Klein (1974, p. 439) comments that "Historical examples of competitive producers of a single money . . . are rare, but the available examples reveal the incentive to overissue." The former Soviet republics provide another example of that phenomenon.

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influx of rubles from Russia. Ukraine began issuing coupons in January 1992 that could form the basis of a national currency (Uchitelle 1992). The future of this scenario is a Ukraine with its own eventually stable currency trading against an eventually stable ruble, at which time inter-republic trade will be able to revive. The future may be a long time coming.

The current legacy of the communist banking and trading systems and hyperinflation is barter, which is now legal. A major aircraft manufacturer has begun making aluminum pots and other consumer items so that it has something to trade for the supplies it needs. Meat can be exchanged for almost anything, as enterprises want meat to feed their employees. High-value items like automobiles are sometimes quoted on the commodity exchanges in units of wheat (Barringer 1991). Coal miners in the Kuzbass spent weeks in the winter of 1991–92 trying to negotiate an exchange of coal for sugar. Associations of private farmers barter produce and meat for flatbed trucks and cinderblock (Banerjee 1991). Even nondrinkers stock vodka for its use in exchange (Albright 1991). Both enterprises and consumers want to be in goods rather than rubles; hoarding is standard.

Trade among the republics is especially important in the ruble area because of the excessive concentration of industry, where often one supplier in the entire territory of the former Soviet Union accounts for 85–100 percent of output of a product (IMF 1991:2, pp. 16, 40). In July 1991 a small enterprise in Russia's Far East reported that it was having difficulty obtaining materials to build water heaters; and yet it was the only plant in the Far East making water heaters and supplied them to not only that region but the entire country (FBIS 29 July 1991, p. 53). Inter-republic trade exceeded 30 percent of output for all republics except Russia in 1988, and over 40 percent for 12 of the republics (*The Economist* 1991, p. 77).

Because of the rapidly depreciating ruble, the U.S. dollar and other hard currencies are being used in trade.[2] The holdings of the population of dollars and other hard currencies are variously estimated at $2 billion to $10 billion or more. The distrust of government on monetary matters is summed up in the February 1992 statement of a Russian traveling in the United States on official business: "I keep my hard currency at home." The desirability of dollars is reflected in their high purchasing power in comparison to the ruble at current rates of exchange, both legal and black market (Ignatius and Hays 1992). At the same time, the successor states of the Soviet Union have inherited a hard currency debt of over $60 billion.

[2]See Copetas (1991) for the flavor of the current business climate.

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In conclusion, the republics are suffering from the absence of effective means of exchange within and among them. They need money that works as a means of exchange internally and across their borders; they need it quickly, to enable them to utilize the economic resources currently available to them; they need a commercial banking system; and they should make use of the hard currency resources held by their citizens.[3]

Free Banking: The Record

The characteristics of a free banking system are freedom of entry and freedom of note issue with minimal government regulation. The role of the government (beyond enabling legislation) is the enforcement of contracts and of laws against fraud and other criminal activity. A free banking system has no central bank and no lender of last resort.

Since F. A. Hayek's publications on competitive currencies in 1976 and 1978, the history and record, as well as the theory, of competitive private currency issue have received renewed attention from Western economists. Historical examples continue to come to light.[4] In most of these cases the monetary standard—the reserve or base money into which the notes were convertible—was the same for all the banks in the system. What Hayek proposed was competition among currencies denominated in different units. He foresaw the possibility that such competition would lead to a monetary standard kept constant in terms of the values of a group of commodities. The essential point he and others have made is that government monopoly of currency issue and the monetary standard has been so pervasive that the market has never had the opportunity to experiment with providing the kinds of money consumers might want.

Whatever the characteristics of the ultimate competitive monetary system, the historical record demonstrates what can be expected of competitive private currency issue, whether or not all banks use the same monetary standard.

The most important historical experience with free banking is that of Scotland between 1716, when the monopoly of the Bank of Scotland lapsed, and 1845, when legislation leading to a monopoly of note issue by the Bank of England was passed. White (1984) summarizes this experience and compares it to that of England. No

[3]McKinnon (1979, pp. 251–54) attributes the success of the Marshall Plan in Europe in part to the European Payments Union (EPU) established with a U.S. contribution of $350 million. The EPU made Europe's currencies convertible, with the dollar as the unit of account, and revitalized trade. Transfers of U.S. capital contributed only about 4 percent of GNP.

[4]See Vaubel (1984) for a summary of the history of private competitive note issue.

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barriers were erected to entry into Scottish banking. All but three banking firms were established as unlimited liability enterprises whose owners were called upon to meet the claims of deposit and note holders in the event of a failure. As of 1765, small note issues were prohibited, the law required that notes be redeemed on demand, and the option clause (giving a bank the option of redeeming notes in six months with payment of interest rather than immediately) was outlawed. These were the only regulations.

England, by contrast, forbade banks to issue their own notes if the bank had more than six partners during most of this time period; after 1826 for a time banks could issue notes if more than 65 miles from London. The failure rate was over four times that in Scotland and losses often fell on note holders, whereas in Scotland losses were almost entirely covered by partners (White 1984, p. 47).

In the United States, "free" banking meant freedom of entry without a specific act of the state legislature, rather than free enterprise. The U.S. experience is in fact multiple experiences with different state laws, some of which worked well and some of which were disastrous. In general, branch banking was forbidden even within a state. Several states used the banks as a market for their bonds, requiring them to purchase state bonds as collateral for note issues but valuing the bonds at par rather than at market. Note issues were restricted to the par value of the bonds; if the par value exceeded the market value, an immediate profit could be made (even as the bank failed) by issuing notes supposedly backed by state securities. This legal restriction is, according to Rockoff (1975), the origin of wildcat banking, which occurred in some states and not others; it was also the origin of the inability of banks to redeem notes as values of state bonds fell, since their assets were thus not well diversified and subject to the problems of the states whose bonds they held. Some states also failed to close down banks unable to meet their obligations.

New England, however, established a stable free banking system that evolved in the same direction as the Scottish system—competitive note issue, notes circulating at par, and clearing arrangements (started by the Suffolk Bank in Boston) among the banks.

New York, the nation's leading center of commerce and industry, also established a stable system. As of 1840, New York's free banking law made the market value of bonds backing note issues the legal value. It specified limited liability unless expressly given up. A minimum paid-in capital was required, and if any of the original capital was withdrawn while debts of the bank remained unsatisfied, no further dividends or dispersions could be made to the owners until

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the capital was restored; if such dispersions were made the bank could be liquidated. New York's law also required a 12.5 percent specie reserve against notes and bills circulating as money, and provided damages for note holders whose notes were not redeemed on demand (Rockoff 1975, pp. 70–79, 81).

In Sweden, privately owned commercial banks with unlimited liability (enskilda banks) issued their own bank notes from 1830 until they were forbidden to do so in 1904; currency issued by the government bank circulated at the same time (Sandberg 1978, pp. 657–65). One of these banks played an especially important role in the development of new Swedish industries. Sandberg (p. 651) attributes Sweden's economic success—including the highest per capita GNP growth rate in Europe between 1870 and 1914—in part to its banking system. No bank failed (Selgin 1988, p. 7).

The cantons of Switzerland permitted banks to issue their own notes between 1826 and 1850, an example of interest because Switzerland had not adopted a single monetary standard at the time. The banks were therefore free to decide in which monetary standard their notes would be denominated. Eight banks of various forms of ownership were established using four different standards. The bank in Basel, which issued currency denominated in French francs, and the bank in Zurich, which denominated its notes in brabanterthaler, accepted each other's notes at a rate of exchange specified by the issuing bank. No failures occurred; some suspensions of convertibility by private nonbank issuers of currencies did happen from time to time (Weber 1988). Regulations limiting note issue and reserve requirements did not affect the behavior of the banks as their note issues were well below the permitted amount and reserves were on average considerably higher.

The record of free banking in a number of countries over periods of time exceeding, in the case of Scotland, a century, and in the United States between 1838 and 1860, is far better than the wildcat banking stories would alone suggest. Nevertheless, one of the essential lessons in the historical record should be how to avoid the conditions that lead to wildcat banking (that is, banks established with fraudulent overissue as the prime purpose).

The theory of free banking has developed side-by-side with the historical re-examination. That theory addresses the significant free banking issues and concludes that (1) a free banking system would not be inflationary (leading to systematic overissue of currency), (2) would not lead to an infinite or indeterminate price level, (3) would not lead

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to monetary disequilibrium or fluctuations in the value of money, (4) would not be unstable (subject to runs and panics), and (5) would not use resources inefficiently.[5]

Both the historical record and theory support the market as an efficient and effective supplier of money. The historical record also demonstrates that when governments decide to end a free banking regime, they (unfortunately) have no problems doing so, and they do so for their own purposes—in order to obtain the benefits for themselves of monopoly issue and the ability to inflate the currency.

A Free Banking System for the CIS

Under a free banking system, each of the states of the CIS, at its own option, would pass legislation permitting private banks to accept deposits of hard currency, gold, or other valuables and to issue notes and establish deposits convertible into a hard currency, a basket of hard currencies, gold, or the current market value of one or more internationally traded commodities such as oil. Each state would further specify that no restrictions be placed on the use of the deposits or notes of private banks in transactions or contracts; that the government provide specific-performance enforcement of those contracts in the same manner and with the same care it enforces contracts in the ruble or any currency issued by, or under the auspices of, the government; and that it enforce laws concerning fraud and counterfeiting.

A license or charter to create a private bank would be based on meeting certain specific and minimal requirements—the names, addresses, and character of the owners (people with a criminal record under current law could be excluded), a copy of the by-laws of the bank representing its contractual commitments and relationships to shareholders, depositors, and note holders, and the names and addresses of its auditors. Each bank could be required to include in its name a standard phrase, such as "non-state," indicating that the bank was not government-owned or backed and that its deposits and notes were not insured by the government. The states might choose to make foreign individuals and enterprises eligible for bank licenses, either as sole or partial owners of a bank.

The enabling legislation in each state would require that contractual commitments to note holders and deposit holders be met. In the event they were not, the government would close down the bank

[5]See Klein (1974), Glassner (1989), Rockoff (1975), Salsman (1990), White (1984, 1989a, 1989b), Selgin (1988), and Vaubel (1987). Selgin (chap. 2, pp. 16–34) and White (1989b) describe hypothetical free banking systems drawing on the historical record and theoretical work.

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according to pre-established rules on the bankruptcy of private banks and the bank's own by-laws on priority of claims.

Each republic could require that every bank provide frequent (perhaps even daily) audited public information on the condition of the bank in accordance with a defined format, posted in all public offices of the bank and made available to the financial press for publication. Further public information requirements would be that the banks post and inform the government of the quantity of all bank notes printed, and that all enterprises printing bank notes for such banks be required to inform the government and the public of the printing of such notes. The provision of public information would probably evolve even if not required by regulation. The assumption here is that a specific requirement can eliminate the time required for market participants to generate the demand for the kind of information they need to evaluate private banks.

Beyond the initial licensing and public information requirements, the governments of the republics would not further regulate private banks. No restrictions would be placed on branching or other geographical activity or the financial services that could be provided (including clearinghouse activities). No reserve requirements would be established and no limits would be placed on interest rates on deposits or loans, the amount of reserves a bank must hold, or the kinds of loans (or even equity participations) a bank could make. (The banks should not be precluded from lending to state enterprises or accepting their deposits. But the government, as owner of state enterprises, may forbid all or some state enterprises to borrow from private banks or hold accounts in them.)

No limitations other than minimal licensing requirements would be placed on entry into the industry (with the possible exception of minimum capital), since competition is the essential regulator of a free banking system. No restrictions would be placed on the conversion of deposits to currency or on the use of devices such as checks, electronic transfers, teller machines, and the like. Nor would restrictions be placed on the nature of the bank's contractual commitments to deposit and note holders, including whether or not it was created as a limited or unlimited liability joint stock company. A bank might or might not choose to issue currency with a delayed redemption clause—one that permits the bank to redeem within six months, for example, rather than immediately. A bank might or might not choose to honor currencies issued by various other banks at one time or another. Clearinghouses would also be free to make judgments about the banks they would accept as members. Currencies issued by banks would trade freely against each other and the ruble.

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To encourage the development of the system, the governments of the Commonwealth states might find it desirable to institute an amnesty, possibly temporary, for depositors of dollars and other hard currencies with respect to the origin or sources of their funds. The state governments may also need to issue guarantees against confiscation or monetary "reform" in which deposits are written down. But the governments would not guarantee deposits or the redeemability of bank notes. Nor would they require the banks to hold any particular assets—especially not government debt or bonds.[6]

The governments of the republics might be tempted to specify or limit the backing for the deposits and notes of private banks. The dollar is the obvious choice, but it is not at all clear that it would be the choice throughout the ruble area or at the end of the decade. The Deutsche mark in the west, the yen in the east, the Finnish marka in the St. Petersburg area, and eventually the ECU are all contenders. Leaving the choice open also allows for gold and for a currency convertible into, for example, dollars but based on the spot price of oil. As Milton Friedman (1991) put it, "Let a common money develop the way a common language has developed, by voluntary cooperation. . . . [T]here is more hope for a viable common money by voluntary cooperation through a market process than by government-enforced cooperation through a political process." New forms of money, as envisioned by Hayek and others, might also emerge.[7]

The CIS formed by 11 of the republics of the former Soviet Union has considered monetary issues. Russia wants to keep the ruble and try to establish it as a sound currency, while other republics—especially Ukraine—are interested in establishing their own currencies. Whether or not the Commonwealth states continue to have the ruble in common, they could agree on the following: (1) to permit the use of currencies issued by private banks across state borders by individuals and enterprises at their option; (2) to determine state by state whether to accept the notes of banks of other republics for tax purposes; (3) to consider whether to permit local branches of banks headquartered in other republics; and (4) to decide whether to provide enforcement of contracts written in the currencies of banks of other republics (a contract would always be enforceable somewhere). If these issues could be agreed upon, then private bank notes redeemable in hard currencies would serve as a medium of exchange among the states of the CIS whether or not the ruble (or any new

[6]A cautious approach to free banking would be to adopt the basic legislation but allow a region, such as a province, to decide whether or not to permit free banking.

[7]See Greenfield and Yeager (1987), Hall (1983), Hayek (1976), and Yeager (1987) for possibilities.

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currency issues of the republics) was sound and whether or not individual republics decided to establish currency boards.

In fact, the CIS might adopt the statement F. A. Hayek (1976, p. 17) proposed for the European Common Market:

> The countries of the Common Market [Commonwealth] . . . mutually bind themselves by formal treaty not to place any obstacles in the way of the free dealing throughout their territories in one another's currencies (including gold coins) or of a similar free exercise of the banking business by any institution legally established in any of their territories.

For their part, the banks would exchange hard currencies for their own deposits or notes. A bank would agree to redeem deposits and notes for its selected reserve currency (say dollars) on demand (or after a specified period of time). Its hard currencies would be converted, in this example, to dollars and invested in (generally) short-term dollar-denominated securities—U.S. Treasury bills or commercial paper. In a competitive system, banks would pay interest on most deposits.

The bank would make loans in its own currency, thus increasing the money supply. But as the deposits were converted to notes and spent, or transferred to others by check, the bank would have to pay out reserves or satisfy claims against it by claims it had acquired on other banks—notes it had accepted or checks to be cleared—thus limiting the expansion of its liabilities to amounts people were willing to hold. Eventually an organized clearing system would develop among the banks, and the clearinghouse or individual banks would make loans to banks temporarily in difficulty.

The Wild East

The free banking system proposed for the CIS differs from historical experience in several respects.

First, in all the known historical instances of private bank note issue, except that of Switzerland, the notes issued by the various banks were all redeemable in the same reserve medium—generally either gold or silver coin, or possibly a government bank note in turn redeemable in gold or silver coin. There was thus a single monetary standard or unit of account. A free banking system would be expected to converge on a favored standard, although this standard might vary geographically (the Soviet Union covered 11 time zones) and over time, and might take a number of years to emerge. The confusion of money denominated in rubles, dollars, marks, yen, and perhaps even

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more currencies is not, however, particularly different from the current situation; it would simply make it legal and open rather than covert.

The legalization of transactions in different monetary standards should move these transactions out of the black market and make them easier to observe and thus to tax. How to tax is more complicated, but the convenience of the government should not be grounds for rejecting an otherwise beneficial policy. If revenues exceed expenses (or value added is positive) in each monetary standard in use, taxes can be paid at the required rate in each standard. If not, each taxpaying entity could be required to select a unit of account and convert transactions in other currencies to that unit—using the actual purchase price, the average for the period, or the value at the end of the period. Alternatively, a republic could require that its official currency remain the unit of account and the currency for tax payments.

Another difference between the proposed reform and the historical record is the recommendation that free banking legislation go into effect while the ruble (and other currencies that may be issued by other republics) continue to exist. The government of Russia appears committed to the ruble as its currency (and if possible, that of the CIS) and to the effort to make it sound. The question then arises of the fate of the ruble in the event free banking is successful and currencies convertible into dollars, marks, yen, gold, or whatever are successfully issued and circulate.

Leland Yeager (1985, p. 105) discusses a transition to a different kind of system in the United States: "The appearance of attractive alternatives would collapse the demand to hold money of the present type." White (1989a), on the other hand, tends to think that government fiat "outside" money would not immediately lose its value if private substitutes were permitted. Hayek (1976, p. 93) comments:

> For government . . . the chief task would be to guard against a rapid displacement and consequent accelerating depreciation of the currency issued by the existing central bank. This could probably be achieved only by instantly giving it complete freedom and independence, putting it thus on the same footing with all other issue banks, foreign or newly created at home, coupled with a simultaneous return to a policy of balanced budgets, limited only by the possibility of borrowing on an open loan market which they could not manipulate.

The ruble is already challenged by foreign hard currencies. The ends of four major hyperinflations of the post–World War I period (Austria, Hungary, Poland, and Germany) occurred not when the central banks of those countries reduced their note issues, but when

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their governments made credible commitments to not finance their deficits by central bank borrowing and to bring their budgets into balance. As Sargent (1982, p. 89) writes, "The essential measures that ended hyperinflation in each of Germany, Austria, Hungary, and Poland were, first, the creation of an independent central bank that was legally committed to refuse the government's demand for additional unsecured credit and, second, a simultaneous alteration in the fiscal policy regime." Presumably it is the same circumstances that are critical to the ruble, and not the absence of alternative currencies or stabilization funds provided by international financial institutions.

Russians to whom I have spoken are convinced that alternative means of exchange would lead to the further erosion of the value of the ruble. But the source of this erosion will be the government's unwillingness to give up its power to finance its deficits by monetary creation and to redistribute income by selectively raising wages or other payments. Under a free banking system, the greater availability of money redeemable for hard currencies would put downward pressure on the ruble/dollar exchange rate. If the government succeeds as well in controlling the issuance of rubles, the ruble should stabilize against foreign hard currencies and bank notes convertible to those currencies. As the government acquires redeemable bank money through tax payments, it can use those notes to purchase and retire rubles. The total money supply would include the notes and deposits of private banks as well as government-issued rubles. (The money supply already includes foreign currencies. Loans issued by private banks should reduce the demand for ruble loans.)

Third, circumstances in the ruble area differ from those in Scotland, Switzerland, Sweden, and the United States during their respective free banking eras. One obvious difference is that modern communications—radio, television, electronic transmissions—exist in the former Soviet Union, even though they are not as pervasive as in Western Europe or the United States. Information need not travel by post, nor bank notes by pony express rather than air.[8] Although Russia (and even more so, the CIS) is vast, it can be assumed that notes would come back to the issuing bank relatively quickly even if circulated at a distance, and information on the condition of various banks would be available throughout the area where notes might circulate. Modern communications mitigate against Friedman's concern that "individuals may be led to enter into contracts with persons

[8]See Gorton (1992) for a discussion of the importance of technology in the pricing of bank notes.

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far removed in space and acquaintance, and a long period may elapse between the issue of a promise and the demand for its fulfillment" (Friedman 1960, p. 60).

Another difference is that the principle of private wealth is not as established or secure as it was in Scotland when the unlimited liability of owners protected so well the deposit and note holders of Scotland's banks, or in the United States where some states passed unlimited liability requirements for owners of banks and consequently made a dead letter of their banking laws. The alternative may be a paid-in capital requirement, not to protect customers against overissues or errors in lending decisions, but to ensure that owners have something of their own at risk and thus have an incentive to make the bank successful.

The problems of establishing confidence in a bank—and its owners—in the republics of the former Soviet Union are also likely to differ from those encountered elsewhere. In this challenging process, the republican governments would be wise not to promise the public that private banks are safe, or in fact to take responsibility for their safety, but only to ensure that information about them is readily available. The first private banks may need to be established by foreign banks of recognized name and reputation or by individuals recognized for their acumen and integrity.

Why a Currency Board Is Not Enough

I have no objections to currency boards, and a government-issued currency convertible into one or more foreign currencies would be a useful adjunct to a free banking system. Without new banking legislation, however, the convertible currency would become entrapped in the existing state-owned banking system with its restrictions on conversion of deposits to currency and its credit and interest rate controls. What is needed is not only a parallel currency or currencies, but a parallel banking system.

The minimal system would permit the establishment of banks under the regime described above but without the power to issue their own notes. Currency issued by the board would be the sole currency other than the ruble. The restriction on note issue would be an artificial restriction on the public's demand for currency to hold in an environment in which individuals are not accustomed to using checks and bank transfers are slow.

A more liberal system would permit private banks to issue their own currencies backed by the currency issued by the board. This system would provide additional flexibility in the supply of circulating currency, but it would still require banks to tender their hard

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currencies to the currency board to obtain reserves. Private banking may attract more hard currency deposits (and thus more rapidly eliminate the seigniorage now enjoyed by foreign governments whose currencies are held in the states of the CIS) if there is no currency board to which a bank is likely to turn over hard currency deposits. This point rests on the possibility of public distrust of a currency board. A currency board is, after all, a creature of the government that creates it, and Soviet history provides many examples of the use of confiscation as a tool of monetary policy. The risk is that the government could seize the assets of the currency board and declare its notes to be legal tender (final payment for debts public and private) inconvertible to the reserve currency. (A currency board run by the IMF would eliminate this risk.)

Competitive currency issue with freedom to choose the monetary standard is no more risky than competitive currency issue limited to a currency board issue as the sole monetary standard and ultimate reserve currency. The advantage of free banking with the right to select the monetary standard as well as issue notes is that it allows competition among alternative reserves. The preferred monetary standard is likely to differ geographically and to change over time, and competing banks are likely to respond more quickly and effectively to changes in demand than a currency board. The variety of monetary standards that would at least initially exist would facilitate trade among the states of the CIS and with the nations of Eastern Europe. A fully free banking system might also attract more new entrants, both foreign and domestic, and thus more rapidly remonetize the economies of the Commonwealth and provide resources to new private enterprises. Finally, free banking offers the potential of developing monetary standards not based on other countries' currencies. Gold is a possibility, as well as the variety of standards having constant commodity purchasing power envisioned in the theoretical literature.[9]

The Transition

The standard approach of Western economists to the transition of a centrally controlled socialist economy to a market economy is to propose conversion of existing institutions of the command economy

[9]In the event ruble stabilization is successful, the monetary authorities in charge of the ruble have an option suggested by Milton Friedman (1984, pp. 48–52) as a way to make the transition to a monetary system without a central bank: that of freezing the supply of ruble notes and non-interest-bearing ruble deposits at the central bank (high-powered money). The ruble would then become one of the competing reserve currencies for private banks.

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to their presumed counterparts in a market economy. Take the state bank and turn it into a two-tiered banking system: an independent central bank and competing commercial banks. Convert the defense establishment to competitive producers of consumer goods. Turn state-owned monopolies into joint stock companies, compensate the managers on the basis of profits, and hope the enterprises behave like competitive private corporations. Sell the flats in government-built housing and call them condominiums. Take the organization that mediates disputes among enterprises with the objective of meeting the goals of the central plan and transform it into a court hearing commercial disputes among private enterprises.

These conversions may or may not work. A parallel approach would permit and facilitate the development of the institutions of a market economy "from scratch." Then, if conversion fails, the old institutions can eventually be shut down, torn down, written off, liquidated, or simply allowed to wither away as new institutions take their place. Money and banking are a good place to start.

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Currency Reform: Is Freedom Enough?

George A. Selgin

The Problem of Currency Reform

Annelise Anderson's excellent paper reminds me of something that happened when I was advising a group of Lithuanian bankers and government officials on the subject of currency reform. Although most of my previous work had been on the subject of free banking—a very radical approach to currency reform—what I proposed in Vilnius, with the help of my colleague Kurt Schuler, was considerably less radical. This was that Lithuania should set up a currency board to issue a new currency pegged to the dollar, or the mark, or the ECU. I was, in fact, very proud of the restraint and pragmatism I demonstrated in putting forth this plan rather than promoting my personal ideological preferences. Imagine my surprise, therefore, upon hearing the Lithuanians' reaction to my plan. "Of course," they agreed, "a currency board would be much less dangerous than a central bank. But why have the government in the currency business at all? Why not simply leave it to private banks to issue currency on a competitive basis?"

That was, perhaps, the last criticism I expected to hear. My initial inclination was to shout "comrades!" or something like that, throw pragmatism to the wind, and go forth with a pure free banking proposal. In the same way, a large part of me was inclined to embrace Anderson's ideas whole-heartedly, all the more so because their author is a distinguished researcher at the prestigious Hoover Institution. And yet, I still have, as I had in Lithuania, reasons for holding back—for resisting what my research tells me is, in fact, the "first best" solution to the problem of currency reform. The reasons are (1) my firm belief that, in this day and age, no government is willing to renounce entirely its prerogative of currency supply, even if

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some governments may be convinced to adopt arrangements for supplying currency that involve a minimal amount of discretion on the part of the monetary authorities; and (2) my belief that competition in the supply of "outside" or "base" money is a far messier proposition than mere competition in the supply of "inside" or "bank" money, including bank notes redeemable in base money.

With regard to reason (1), it is an indisputable though perhaps regrettable fact that governments continue to look upon currency as a symbol of national sovereignty. Thus, quite apart from any considerations of seignorage, monetary control, and whatnot, governments are determined to have their citizens employ as base money a currency produced by the government and bearing its "brand name." This phenomenon has been a factor in monetary politics since ancient times, when governments first monopolized coinage and emblazoned coins with rulers' portraits. It is certainly a factor of major importance in the former Soviet republics, which (apart from Russia itself) are seeking to replace the ruble with currencies of their own as much to certify their independence as to achieve some form of monetary control.

Turning to reason (2), it is crucial to distinguish competition in the supply of base or standard monies from competition in the supply of bank monies. (A third category—the competitive supply of a single base money, as when several private mints compete in the production of gold coins based on the same monetary unit of account—does not concern us directly here, though I may remark in passing that it can be perfectly beneficial as long as the products of distinct producers can be identified.) Historically, as Anderson recognizes, "free banking" has involved the second kind of competition only. Base money in historical free banking systems consisted of units of the precious metals—gold or silver—that provided the basis for claims issued by the banks and denominated in the same units. Thus, historical free banking systems emerged in economies where some monetary standard was already long established. Free banks contributed substantially to the efficiency of established standards by providing low-cost substitutes for coin in circulation, but they did not in any way determine the monetary standard itself—which evolved over a long period of time and predated banking (see Carl Menger's 1892 classic account).

Why is this important, and what bearing does it have on the practicality of free banking as a basis for monetary reform in the Commonwealth of Independent States (CIS)? It is very important, in my opinion, because it suggests that, while free banking may represent a commendable means for improving the performance of an established monetary standard, choice in currency may be a

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less-commendable means for establishing a new standard (or standards) in place of what already exists. The reason is, as I have indicated, apparent in history. Past free banking systems have had little or nothing to do with the selection or emergence of monetary standards, because the emergence of such standards was itself a time-consuming evolutionary process that historically and logically came prior to the emergence of banks. Now it may, indeed, be possible to repeat this process in the CIS by relying on the widespread use of Western currencies to hasten it. But to do so could result, not in the rapid emergence of a new and superior standard money, but in the prolongation of existing conditions with a corresponding delay in the development of banking facilities, free or unfree. Anderson in fact comes close to admitting as much, writing that "The confusion of money dominated in rubles, dollars, marks, yen, and perhaps even more currencies" that might prevail under her proposed reform would not be "particularly different from the current situation; it would simply make it legal and open rather than covert." The problem, of course, is that the current situation is a disaster, which any reform worthy of the name must aim at rapidly eliminating.

In support of the fear expressed above, one can point to numerous, well-known instances of standard monies that remained in use despite hyperinflations that were rapidly eroding their purchasing power. Although alternative monies came into limited use alongside these eroding standards, the latter remained dominant media of exchange until the bitter end of the inflationary episodes in question, which typically involved some government-sponsored switch to a new standard money. This tendency is no less marked in the CIS, where the ruble remains a dominant money despite a high rate of inflation and the increased use of alternative means of exchange, including barter. While it cannot be denied that the growth of competitive banking facilities based on alternative, more stable monetary standards would encourage greater reliance on those alternatives, growth of such facilities cannot be taken for granted.

A very real risk exists, therefore, that even in a free-market setting an inferior currency will remain dominant for some time despite the fact that its inefficiency is recognized by everyone. It is the old story of inertia favoring an established though inferior money over superior but upstart rivals. Everyone would like to see a switch, but no one wants to go first; there is, in more technical terms, a "network externality" aspect of monetary exchange that makes the adoption of a superior standard something like a public good. The inertia effect will be especially marked if the government, following Anderson's

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suggestion, requires "that its official currency remain the unit of account and the currency for tax payments." Relying on free-market forces alone to bring about a change of standard would mean, in effect, waiting for conditions to get so bad that even a powerful inertia can be overcome. It is not difficult, for me at least, to see how it might be better for the government to take an active part in abandoning (instead of propping up) the incumbent standard, thereby minimizing the waiting period, even if it means establishing a standard that is not as ideal as the one the market might eventually put into place.

The Currency Board Alternative

The currency board approach allows the government to use its position as a major economic agent to sponsor a concerted move to some superior standard money. This is, admittedly, a more constructivistic alternative than that of "starting from scratch" and letting the market decide the standard. It is also one that involves a greater risk of continued politicization of the money supply. In reply to these criticisms, I want to point out, first of all, that a currency board approach is fully capable of preventing manipulation of the stock of base money by the host country, while still allowing it to exercise a symbolic form of monetary sovereignty. This is, after all, far better than the alternative of national central banks issuing independent currencies, which is the preferred solution of most members of the CIS, and which is almost certainly bound to be their choice if they are encouraged to choose between it and the alternative of complete laissez-faire.

Second, there can be no real question of starting from scratch. As I have indicated above, for the government to do nothing but simply allow the market to establish a new standard over time would not be equivalent to starting from scratch; it would, rather, tend to perpetuate the status quo; the contest for a new monetary standard would be like a horse race where one (albeit lame) horse is already halfway around the track before the others are permitted to leave the starting gate.

Finally, and as Anderson recognizes, allowing the government to participate in the reform process by sponsoring a new standard money is not equivalent to ruling out choice in (standard) currency. For example, if Moldavia established a ECU-based currency issued by a currency board, that need not prevent private firms from offering banking services on the basis of some other standard money, for example, gold or U.S. dollars. Indeed, I agree that the law should include a clause, such as the one from F. A. Hayek reproduced in Anderson's article, explicitly providing for such competition. Nevertheless, the fact remains that, despite potential competition, the ECU

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would almost certainly prevail as the dominant money, thanks to the government's patronage, just as the ruble might prevail if the government elected to simply "let the market decide." The horse race would still be rigged, but at least the favored horse would be a better horse than before.

An additional criticism of the currency board approach, raised by Anderson, is that the board would be subject to the risk of government confiscation of its foreign currency assets, which would turn the board's notes into yet another example of inconvertible fiat money. The risk can, however, be easily avoided by means of a number of precautions such as were recommended by my colleagues and me in our proposals to Lithuania. The currency board could be established as a private firm, so that its assets would not belong to the government. The board could, furthermore, maintain its legal seat as well as its investments outside of the home nation, for example, in Switzerland. Finally, foreign nationals could serve as board directors, and directors could have staggered terms, to insulate the board as much as possible from domestic politics (Schuler, Selgin, and Sinkey 1991, pp. 14–15).

Conclusion

All that I have said thus far has concerned the relative merits of a currency board versus those of competition in the supply of base or standard monies as strategies for monetary reform. As far as competition in the supply of bank money, including redeemable bank notes, is concerned, I am happy to endorse a radical, free banking solution. I agree, furthermore, with Anderson's claim that a currency board reform will work best if private banks are allowed to issue notes on the basis of fractional reserves of currency board money. This approach ensures that the supply of currency, including bank notes, will be flexible enough to meet seasonally and cyclically fluctuating demands. It would also encourage greater substitution of bank (inside) money for government (outside) money, with a corresponding substitution of internal for external lending. The last would imply a greater role for the monetary system in sponsoring domestic economic development.

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Monetary Reform in Russia: The Case for Gold

Alan Reynolds

Convertibility, Monetary Overhang, and Central Banking

In the early debate about monetary reform in Russia, convertibility seemed to be something both separate and more urgent than stability. As the International Monetary Fund (IMF) defines it, "convertibility" seems to mean making rubles more useful to foreigners than to local citizens. An IMF paper even objects to letting ordinary Russian citizens have access to foreign currencies, because "residents will have the foreign exchange needed to make payments for imported goods and services" (Greene and Isard 1992, p. 17). To acquire foreign currencies, though, people will have to sell goods, services, or assets. That gives individual Russians an incentive to produce, and the means by which they can and should buy imported or domestic goods and assets.

In the same IMF paper, Joshua Greene and Peter Isard also worry that internal convertibility "may make it very difficult to maintain effective restrictions on capital outflows. . . . Many economists and policymakers have traditionally argued that . . . countries should not rush to liberalize restrictions on international capital movements." It is true enough that many economists have favored free trade in goods, but not in claims to goods (capital). This is not a logical distinction, but rather a psychological problem afflicting many economists at the IMF and elsewhere (Flanders 1989, p. 339). By contrast, John Giuseppi's history of the Bank of England rightly notes that London's free market in currencies and securities was, even in the 1930s, considered "vital to the country's foreign trade, to the imports on

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which its economic life depended and to the exports by which they could be paid for" (Giuseppi 1966, p. 171). By the standards of this bit of IMF scholarship, London always followed a dangerous policy.

The alleged "monetary overhang" of 1991 was another distraction of that period, which has already been used, as Howard Wachtel (1992, p. 48) put it, to justify "the utter irrationality of deliberately inducing a hyperinflation . . . solely to confiscate people's earnings [and savings]." Since ruble currency constitutes nearly all of the publicly held national debt, massive devaluation amounted to almost total repudiation of the government's debts to its citizens. To make matters worse, there have been periods in which the Russian government has completely demonetized "old rubles," as in July 1993, thus arbitrarily confiscating monetary wealth above some trivial sum. Such whimsical assaults on property rights destroy the moneyness of money, probably increasing long-run inflation despite the destruction of part of the currency stock (because people become unwilling to hold cash balances for more than a very brief period).

To more than match the so-called monetary overhang, the governments of the Russian Federation had a much larger "overhang" of real assets that could have been easily marketed, such as houses, shops, trucks, mineral rights, portable electric power plants (nuclear submarines). They also had the possibility of issuing dividend-paying shares in, say, privatized electric and telephone companies (Mikheyev and Reynolds 1992).

Actually, the ruble is already relatively "convertible" for current account transactions. The exchange market is relatively free, and businesses can buy hard currency at market rates. Yet the ruble is simply not convertible at any stable, predictable rate, making long-term business plans more than difficult. The ruble can never be totally acceptable in international markets for goods and financial assets yet shunned at home. Instead, the ruble, or some alternative accounting unit, must be made literally convertible into either hard currency or hard metal on demand. Whether this is done through a currency board or a central bank may well affect how believable the initial stabilization effort appears. Yet the form of institution is nonetheless a secondary issue compared with the nature of the convertibility the institution provides, and its demonstrated resolve in providing a sound currency. It is certainly true that central banks have most often earned very little credibility, particularly in Russian history. However, proposals relying on currency boards also assume there must be a single monopoly issuer of currency, even though any such issuer is bound to be subject to political pressure.

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Annelise Anderson (1991) has instead made a strong case for free banking in Russia, where it seems particularly useful in order to help repair the underdevelopment of banking and finance. Although the number of banks increased from 6 in 1987 to 1,500 in 1991, many have undiversified assets and look precarious (*The Economist* 1992). Most banking still consists of exchanging claims against the bad debts of state enterprises. In any case, "whether currency is issued by private competitors or public monopolies, a key question is how the issuer can be held accountable for maintaining the money's value" (Reynolds 1985, p. 107).

On monetary policy, as with tax policy, mainstream advice has often begun with the wholly inappropriate assumption that these struggling republics can simply legislate the same sorts of policies that might work, or at least be bearable, in more advanced economies (such as generous "social services"). An otherwise competent OECD report, *The Transition to a Market Economy*, proposes that "the quantitative regulation of the money supply should give way to more subtle means of regulation, primarily through open market operations, using government bonds" (Marer and Zechinni 1992, p. 205). Such unthinking trust in central banking is another one of the few surviving remnants of central planning, along with capital controls, public schooling, and "free" medical care. Yet the familiar central bank manipulation of fiat money cannot possibly work in Russia. There is no efficient market in safe securities, therefore no possibility of conducting open market operations in anything but gold or hard currencies, even on the OECD's remarkably innocent assumption that government central banks can be trusted to be "subtle" about buying government bonds.

Arbitrary measures of money, such as M2, which combine deposits and currency, are even less informative than usual in this case. There have been restrictions on the exchange of currency for bank credits: "Enterprises are restricted to using currency to purchase labor services and often find their excess non-cash credits confiscated through taxes" (Feige 1991, p. 634). There is also enormous barter, both between individuals and enterprises (Maney 1991b).

Most transactions in Russia are based on currency and commodities, so the currency's instability in terms of commodities is quite crucial. Hoarding of thousands of relatively illiquid commodities, for possible use in later transactions, is a terribly wasteful alternative to providing a currency that can instead serve as a store of value. This private resource cost of unsteady fiat money may be much larger than the cost of maintaining commodity reserves for money. As has been true in all hyperinflations, there has been much talk in the Russian

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press about a "shortage of money," which simply means that the government cannot print currency rapidly enough to keep up with rising prices, as velocity soars. At that stage, anything that improves confidence could have sudden disinflationary impact, since the demand for money always soars at the start of stabilizations, due to remonetization (this presents a dilemma for "quantity rules," which cannot accommodate a surge in demand for money resulting from successful stabilization).

The Lamanski Plan

The monetary problem in the Russian Federation is a matter of demand for the entire stock of rubles, not simply for the incremental flow. Even freezing the flow of new notes and deposits might not help much, unless accompanied by a viable, long-term tax and spending policy, as well as a set of institutions that would virtually prohibit renewed monetary debasement.

Three excellent first steps toward serious institutional reform might be called the "Lamanski Plan." Lamanski was the deputy governor of the Bank of Russia in 1861. He proposed (1) making the government-controlled central bank into an independent private enterprise, (2) selling such state assets as railroads and forests to stop chronic budget deficits, and (3) requiring that any new currency be issued only against deposits of gold or silver coins (Conant 1896, pp 238–39). This plan was never fully implemented. It ran into problems in 1862 as the bank got involved in inflationary financing of land to emancipate the serfs, who were soon "exploited by the state" (as Marx put it) through brutal taxation.

Lamanski's basic ideas nonetheless have considerable merit. First, a wholly private central bank, or currency board, is more likely to remain relatively independent of government pressure. The privately owned Swiss National Bank, for example, will not hold central government paper, but instead holds a lot of gold. At a minimum, Lamanski's first rule suggests that any monetary authority in Russia must be prohibited from issuing currency in exchange for the debts of republican governments or state enterprises. This reform was also part of Stanislav Shatalin's ill-fated "500-Day Plan." Second, selling state assets not only provides immediate budgetary relief, as Lamanski emphasized, but also the prospect of converting formerly subsidized enterprises into sources of future tax revenues (including sales and payroll taxes) through efficient operation. Bureaucrats have no incentive to manage efficiently. Third, Lamanski's idea of limiting the increase in new currency to the increase in new reserves, whether of gold or hard currencies, would certainly make it quite difficult to

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finance a continuous, serious inflation. Indeed, confining new note issue to gold and foreign exchange was, in addition to cutting income tax rates from 60 percent to 30 percent to stem capital flight, the first step that Poincaré took toward restoring a gold standard in France on August 7, 1926 (Haig 1929, p. 210). It would be highly desirable to at least add gold to foreign exchange as a significant portion of the monetary base, as Poincaré did in France, and as Estonia is doing right now.

Even if we could accomplish Lamanski's three goals—a reasonably independent currency board (or central bank), massive asset sales to retire some of Russia's non-interest-bearing debt (that is, money), and a rule that any new currency issues must be backed by gold and foreign exchange—the ruble would still be undefined and inconvertible in terms of some generally acceptable asset, such as gold or dollars. Thus, we need to find an anchor for the ruble. The first possible monetary anchor is to define the ruble in terms of a foreign currency, as we have already discussed above. A second is to define the ruble (or some new currency unit) in terms of gold, making the ruble literally convertible into, say, gold coins. And a third is to permit the private sector to develop and use a parallel currency, probably defined as a measure of gold (widespread use of U.S. Federal Reserve notes in Russia and elsewhere shows that a parallel currency is quite feasible, though this one involves an avoidable gift of seignorage to the United States).

The second option, a classical gold standard, would not be as difficult to accomplish as many have suggested. Initial interest in an official gold standard in Russia quickly faded because (1) it was rumored that official gold reserves were much smaller than previously thought, and (2) economists therefore theorized that any promise to redeem rubles for gold would soon deplete the remaining gold stock. The first point is not valid, because the government could acquire more gold by selling other assets, and certainly does not need anything approaching a 100 percent reserve to implement gold convertibility. The second point is not valid either, because the risk of a run on the gold window depends on the price at which convertibility is pledged. If the United States promised to redeem dollars for gold at $500 an ounce, for example, there would be no immediate risk at all of draining Fort Knox, since dollars currently have a higher gold value on the world market. However, such a golden guarantee behind Federal Reserve notes would nonetheless put a cap on the risk of future inflation. This same logic applies to Russia.

Russia's official gold hoard was thought to be something like $30 billion in late 1991, though subsequent reports suggested it may be

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much smaller, perhaps only $3 billion. Even a small gold stock could suffice to defend the currency (particularly if the state were prepared to sell assets or bonds to acquire more gold), once the expectation of perpetual budgetary hemorrhage and "soft budget" financing of state enterprises is stopped (this is why supply-side tax policies and privatization are so essential). By some estimates, the stock of rubles (measured by exchange rates that often priced the ruble below purchasing power parity) was worth only about $5 billion in 1991, while the public held roughly twice that much in hard currencies. Even if the gold hoard was only $3 billion at that time, it would still have been enough to retire over half of that estimated dollar value of paper rubles. Whatever the precise figures, the main point is that retiring rubles in exchange for gold coins (and other state assets) would raise the demand for remaining rubles, thus raising their value. To suppose that all rubles would disappear under gold convertibility (regardless of the guaranteed gold price in rubles) is to forget that the gold value of the shrinking ruble stock would rise if the rubles were properly retired from circulation upon being redeemed for gold.

There would be no insurmountable technical obstacles to putting an official golden floor on the value of rubles, or some other republic's currency. An adequate gold reserve could probably be built by selling state assets to both citizens and foreigners, and using the proceeds to rebuild gold reserves. But there is little point in holding gold to back a currency if the gold will never be used to defend the currency, as in the case of U.S. gold reserves held at Fort Knox. After developing a workable tax system and retiring rubles for state assets, the Russian government could simply offer to redeem rubles for gold at a gold price that seemed fairly high at the time—the equivalent, say, of 500 U.S. dollars per ounce. This guarantee would never become effective unless the money supply expanded beyond demand, in which case redemption would automatically retire surplus rubles. That is essentially what an "official" or monopolized gold standard does—it provides a golden parachute for currency holders who get scared.

A minimal "official" reform would thus expand on the Lamanski plan by including (1) an effective prohibition of creating new money to cover deficits of the government or state enterprises, and (2) a guarantee to redeem rubles for gold at a price above the current market rate. All of this is technically feasible, assuming as I do that proper tax reform can make long-term budget balancing feasible. And it could even be effective, if anyone believed it. Yet the trouble with this, or any other plan relying so heavily on Russia's politicians and central bankers, is that it would be quite difficult to establish credibility and trust.

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One Possibly Viable Option: Fixed Exchange Rates

The value of fiat money rests entirely on confidence. It is a confidence game. Since none of the new republics has any reputation to rely on, any "market" or floating exchange rate must contain a gigantic premium for uncertainty—for risks that are unknowable and therefore likely to be exaggerated. When it became known that the East German mark would be exchanged at a favorable rate with the West German mark, the so-called "free market" rate naturally went way up. Something similar briefly happened in Russia in early 1992, as the ruble went up on rumors that authorities at least did not want it to go down. In early 1993, statements by U.S. Treasury officials that they wanted the dollar to fall against the yen quickly produced that result. There is no point talking about a "realistic" or "free market" exchange rate in the case of government-monopolized fiat money, since the exchange rate is mainly based on expectations about future government policy, massive uncertainty, and raw fear.

In mid-1992, after the ruble had staged a brief recovery, "a visiting IMF team" was "attempting to persuade the authorities to stick to their original idea of floating the ruble" (Boulton 1992). Yet the IMF team surely knew perfectly well that to even announce that authorities want the ruble to "float," even temporarily, is just a euphemism for letting it sink like a stone. If people are told that nobody in charge cares whether a ruble is worth a tenth of a cent, or much less, the ruble is going way down and prices are going way up. Even former IMF economist John Williamson was troubled by this familiar IMF fetish with perpetual currency debasement, which had already produced hyperinflations in Yugoslavia and Latin America. Williamson (1992) rightly argued that the Russians should "nudge the ruble up to a level worth stabilizing."

It would, in principle, be a great improvement to fix the ruble's value to a more credible foreign currency, such as the U.S. dollar. This could certainly be done through a currency board, rather than a central bank, or through some mixture of the two (as in Estonia). As the Federal Reserve Bank of Dallas pointed out in its 1991 *Annual Report*, "a country with a fixed exchange rate has an added incentive to limit inflation, and the private sector knows it." Continuing to inflate while exchange rates were fixed would make the country's products uncompetitive, and cause a conspicuous depletion of foreign currency reserves. But breaking the fixed exchange rate causes a burst of inflation, and acute political embarrassment.

The way in which currency boards limit inflation is not magic. They simply impose fixed exchange rates—a "clean" fix, or "unified currency,"

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with no exchange controls and no gap between market and official exchange rates. "A currency board can, in essence, be viewed as a pegged exchange rate system under which open market operations, and thereby sterilization, are prohibited" (Bennett 1993, p. 457). Yet some of the most vocal proponents of the currency board solution for Russia are monetarists, who have been equally zealous in their advocacy of floating exchange rates. One suspects that some of the fascination with currency boards (that is, fixed exchange rates) may be that the concept provides camouflage for the reluctant rediscovery of a simple fact: it is extremely difficult, if not impossible, to discover a single example of rapid inflation in world history that has ever been permanently ended without fixing the currency to either a more-credible foreign currency or to a precious metal.

Like a currency board, a central bank (particularly one that is prohibited from monetizing government debt) has the technical ability to conduct monetary policy with the sole objective of maintaining a fixed exchange rate—by, for example, shrinking domestic credit when foreign exchange reserves fall. The recent monetary reform in Argentina, which requires new currency to be fully backed by gold or hard currency and fixes the exchange rate to the dollar, is an example of plan that retains a central bank but deprives it of the ability to inflate. The hypothetical advantage of a currency board is that continuous convertibility between the domestic and foreign currency (such as 7.8 Hong Kong dollars per U.S. dollar) provides simplicity and transparency, and thus may not be so easily subject to political abuse. However, currency boards cannot be entirely immune to such abuse. After all, there used to be many currency boards, but most no longer exist. Even Hong Kong discarded its currency board for some time, before reviving it in 1983. While it is highly plausible that a currency board would have more credibility, and perhaps more endurance, than a central bank, it must not be forgotten that the proposal for a Russian currency board only works if the exchange rate of the ruble can, in fact, be fixed to that of, say, the dollar.

Can a fixed exchange rate be maintained? The answer is that it can, provided that (1) the budget is approximately balanced in a present value sense through tax reform, privatization, disarmament, and repeal of subsidies; (2) any money-issuing authority is prohibited from financing the deficits of government and state enterprises (particularly at below-market interest rates); and (3) the money-issuing authority is prepared to convert the local currency into a hard currency at a preannounced exchange rate.

If desired, to minimize any adjustment costs of rapid disinflation (which should be minor, due to the rarity of long-term labor or credit

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contracts), the move to fixed exchange rates could be phased in, starting with a crawling peg. Actually, it is less important that the exchange rate be literally and immediately fixed than it is to make a firm commitment to a schedule of future depreciation that would be predictable and consistent with moderate inflation. David Teolis and George von Furstenberg (1993, p. 5) make this point as follows:

> The essential difference between fixed and floating exchange rates is not that the nominal exchange rate is unchanging, but that its future course is unconditionally laid out for some time ahead. Hence, prescheduled devaluations of the central rate by a preannounced amount can provide as certain and unconditional information on the future course of nominal exchange rates as a fixed parity.

Colombia, for example, has maintained an inflation rate of 20–30 percent for decades by using a crawling peg, and economic growth (helped by lower tax rates) has been quite satisfactory. Mexico recently held inflation to about 10 percent by regularly scheduled mini-devaluations, which became smaller over time. Although much less desirable than a lower inflation target, such a predictable policy of moderate inflation through prescheduled, shrinking devaluations would at least represent a major improvement over recent Russian experience with high and volatile inflation. Once a country achieved a sustained period of inflation in the 20 percent range, it would be relatively easy to later bring that down to single-digit inflation in a second stage of monetary reform. It is not easy to imagine, though, how a crawling peg could be implemented by a currency board. This all-or-nothing feature of currency boards may be a disadvantage, making it impossible to move toward fixed exchange rates gradually, over a period of two or three years.

A potential problem with keeping the ruble rigidly fixed is that either variety of currency monopoly—currency board or central bank—would have to maintain a sizable reserve of liquid assets denominated in dollars to exchange for rubles. How could either institution acquire and retain such a war chest? Asking other countries to supply such a "stabilization fund," as the League of Nations did for Austria, Hungary, and Poland in the 1920s, would not be a permanent solution even if the big industrial countries were so inclined. Even if such foreign debts never had to be repaid, the fund would probably be quickly depleted if there were no regular flow of dollars coming in through trade surpluses or net capital inflows.

Russia is not Hong Kong or Singapore. There is not much trade and tourism, and little foreign investment income, to bring dollars in. If a currency board had to expand and contract the ruble currency stock to conform only to fluctuations in trade income, the effect could

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be perverse. A vigorously expanding economy would have to retain for domestic industry the metals, fuel, and other materials that are now available for export during the current depression. Indeed, vigorous economies typically run sizable current account deficits (that is, they attract net capital inflows). But in regions using the ruble, any growth-related future current account deficits are likely to be matched by relatively illiquid capital inflows, such as the Turks doing construction projects in barter deals for natural gas. In such cases, no hard currency changes hands. With highly undeveloped capital markets, capital inflows may be too unreliable a source of liquid foreign exchange to serve as backing for Russian money. Aside from such foreign investment, the only other way hard currency reserves (and therefore the money supply) could increase would be net export receipts, which often contract as an economy expands. A currency board that issued money only in exchange for foreign currencies (and not in exchange for gold) might therefore have to shrink the money supply whenever the economy was doing well and therefore running a trade deficit. This would not be helpful. But there is no reason why a currency board could not exchange local currency for, say, gold coin and gold certificates, rather than for foreign money.

There is no doubt that fixing the exchange rate of the ruble, or even limiting the rate of depreciation (a crawling peg) would be a substantial improvement over the recent monetary chaos—if it can be done. The practical question is whether monetary stability could, in this case, more likely be achieved and maintained by making some monetary use of gold, either as part of the currency board's initial monetary reserve or as an alternative unit of account (parallel currency) provided by competing private banks.

One value of focusing on a fixed exchange rate (and on creating the monetary and fiscal institutions and conditions that would make a fixed exchange rate feasible) is that it elevates monetary stability above the obsession with balanced trade. Monetary policy cannot serve two masters: trade balance and price stability. If the ruble is always allowed to sink, because past devaluations made prices "uncompetitive," then monetary policy will be chasing an illusion. The next devaluation always has to be larger than the last, in the idle hope of keeping the "real" exchange rate down as inflation escalates. To worry that the ruble will become "overvalued" without an endless series of devaluations is just another way of saying that soaring prices are perfectly acceptable, and must be shielded from any consequences. If raising prices is never allowed to affect "competitiveness" and market share, at home or abroad, then competition cannot perform its essential function of disciplining excessive price increases.

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Cigarettes Are Better than Rubles; Gold Is Better Still

An alternative or supplement to converting rubles into foreign currencies is to instead back and redeem rubles in some commonly accepted, homogeneous real assets or commodities. By choosing a domestic anchor for the currency, at least as one more component of the monetary base, Russia would not have to rely so heavily on trade surpluses and inflows of foreign capital to increase the monetary base (though currency stabilization and tax reform would attract foreign capital, thus making this less of a problem).

A predictable "standard" requires some readily measurable, storable, divisible, and homogeneous commodities whose value is not overly influenced by domestic or foreign supply shocks. American brand-name cigarettes fill some of these requirements fairly well, while fresh fish or acres of land do not. Marlboro cigarettes would be a far better money than today's rubles, which is probably why Soviet bosses tried to impose a 1,000 percent tariff on them. Yet the ruble was so feeble by early 1991 that a pack of Marlboros nonetheless dropped to 75 cents a pack, and U.S. cigarette exports to the former Soviet Union jumped to $60 million in the first half of that year, up from $869,000 a year earlier (Maney 1991a). Branded cigarettes meet the classical economists' requirements of portability, homogeneity, divisibility, cognizability, and, to some extent, durability. However, if we can overcome some modernist prejudices, it is not too difficult to come up with something even better than Marlboros that is also potentially available within the Commonwealth of Independent States (CIS) itself.

The academic allergy to commodity money, particularly gold, is an arbitrary limitation on the alternatives. After all, there are not so many good options in this case that we can afford to ignore something as valuable as gold or silver, just because it is out of fashion in government circles. It is clear from the behavior of gold prices in periods of monetary uncertainty, such as 1980 or 1993, that individual savers throughout the world, unlike their governments, never really left the gold standard. Opposition to commodity money is also naive in this instance, since commodities are already being used as quasi-money in the CIS—cigarettes, blank video cassettes, and a wide variety of tangible assets traded on numerous commodity exchanges.

There is an unfounded fear that moving to a gold standard would be too effective, in the sense of squeezing the real economy. I once surveyed previous periods in which a gold standard was reinstated, such as the United States in 1792 and 1879, Britain in 1821, and

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France in 1926–28 (Reynolds 1985). What I found is that in every resumption of gold convertibility, with the partial exception of Britain's deliberate deflation before 1925, there always followed a period of extraordinarily brisk economic growth for four to ten years. Warren Walsh (1958, p. 314) notes that this was also true during Russia's prosperous period on the classical gold standard after June 7, 1889, when government bonds could be sold with a yield close to 4 percent: "There were almost 6,000 more enterprises in 1900 than in 1890, and close to a million more workers." Moreover, from 1894 to 1914, foreign investment was enormous, and Russia's industrial production rose from 41.6 million gold rubles a year in 1888 to 1892 to 161.2 million from 1892 to 1897.

Despite the intellectual appeal of diversification, and therefore of "baskets" of commodities, there are very few commodities that could function well as money, or as monetary reserves. Sympathetic critics of golden money, such as Robert Hall (1983) and Michael Bordo (1984), worry that the short-term purchasing power of gold appeared to be "unstable" in terms of ancient price indexes dominated by wheat and corn. But this simply demonstrates what we should already know: that farm prices are quite variable in terms of gold, not the other way around. Marc Miles (1984, p. 226) writes that a gold standard "cannot guarantee to keep the dollar price of corn or aluminum from changing." Of course not. Whether prices are expressed in ounces of gold, or anything else, relative prices must be free to change in terms of that *numéraire*. No monetary system, actual or hypothetical, can or should prevent the price of corn or aluminum from changing.

Milton Friedman's ([1951] 1953) classic essay on a commodity-reserve currency essentially narrowed the practical list to metals. However, world prices of cyclical metals, such as copper and aluminum, have, like farm prices, been quite volatile relative to the precious metals. The dollar price of aluminum was cut in half in 1991, for example, and copper bounced up and down, while gold hovered in the $340–360 range for several years in the late eighties and early nineties. If the stability of the dollar in terms of gold continues, then a Russian monetary system based on gold would not yield results much different from one based on dollars, except that it might have more credibility since the availability of domestic gold makes redemption more feasible. If the gold value of dollars once again falls, as it did in early 1993, a gold-based system would prove superior.

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Gold Backing Creates Instant Credibility, Once Again

Discussion of the role of gold in a currency stabilization plan for former communist countries is no longer merely hypothetical. Estonia issued the kroon on June 20, 1992, "backed primarily by 11.3 tonnes of gold" (Marsh 1992). In marked contrast to the unbacked Ukrainian "coupon," the Estonian kroon was by far the most stable currency in the region over the following year. This is quite a remarkable achievement for a brand new currency issued by a small country. Both currency and commercial bank reserves in Estonia are "backed" by gold and foreign currencies. This is similar to the first phase of reform by Poincaré in France in late 1926, prior to establishing full convertibility into gold. Such a backing rule, by requiring assets to match liabilities, enhances the acceptance and credibility of the unit of account (for example, the kroon). The backing rule in Estonia is importantly reinforced by a fixed exchange rate, at 8 German marks per kroon. The system uses both a currency board and a central bank, illustrating our point that the institutional form may be less important than the reality of acquiring a reputation of abiding by sound monetary rules. The system is too new to have weathered the essential test of time, but nonetheless did hold Estonia's inflation to about 40 percent in 1992 (Buyske 1993). There has been some speculation that the combination of such inflation with a fixed exchange rate may lead to devaluation (rather than to lower inflation), thus "propping up the long end of the yield curve"—but this has also happened from time to time in Hong Kong, which has nonetheless resisted such pressures for a decade (Bennett 1993, p. 458).

Uzbekistan also reportedly toyed with the idea of introducing its own gold-backed currency, but recently opted for a pure fiat currency. Such backing is of symbolic importance, particularly if it limits new issue of currency. But gold can really ensure long-term stability if and only if the new currency becomes literally convertible into gold coins or bullion. In that case, any excess note issue would be redeemed for gold, making such excesses impossible.

We may not be sure what the "optimal currency area" is, but it is surely larger than Estonia or Uzbekistan. Ideally, most of the region we used to call the Soviet Union would benefit enormously from a common currency that is anchored to something of generally accepted value across national borders and across generations. In theory, this anchor could be dollars or marks, though these are

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difficult to acquire. Gold, however, is potentially available in adequate amounts, both from public and private hoards, and from new production.

If a private or public monetary authority has the gold to back a currency, it can of course acquire dollars, and vice versa. A system that promised to convert rubles to dollars at a fixed rate could hold most of its reserves in gold rather than dollars, and then sell dollars at the prevailing rate if there was a "run" on dollars. But that roundabout conversion process would add to risks that the primary commitment (to redeem rubles for dollars) would not be met by dipping into secondary assets (gold). For one thing, the need to sell gold for dollars might arise at a time when the price of gold was unusually low, in terms of dollars. And even if that was not the case, there is no obvious way of compelling those holding gold reserves to sell them. The United States, for example, decided in 1971 that it would rather hoard gold at Fort Knox, for some unknown reason, than meet a commitment to exchange gold for dollars held by foreign central banks. Had ordinary citizens been promised that their currency could be exchanged for gold coins at $42 an ounce, it seems far less likely that the U.S. government's failure to redeem would have been so politically painless as it was. The first advantage of gold convertibility over dollar convertibility is therefore transparency—those holding rubles can easily tell if authorities are not meeting the commitment to exchange their paper for gold coin or bullion.

A second advantage for gold is that it facilitates a de facto common currency. Making currencies of various republics convertible into gold could satisfy the demand for separate monies in the republics, yet tie them together by their common bond to gold. This arrangement would provide the advantages of a common currency (similar to the advantage of speaking a common language), as Western Europe has been trying to do with fiat monies, but without great success.

A third advantage of gold is that it insulates the country against spells of monetary mismanagement by the country to which its currency would otherwise be pegged. Both the Federal Reserve and Bundesbank have experienced periods of high inflation and high interest rates in the past decade or two, which were not periods in which it would be pleasant for other countries to peg their exchange rates.

A fourth advantage of gold-based rather than dollar-based convertibility might not be relevant in places with more secure property rights, such as the United States or Western Europe, but it is quite relevant to the region that extends from Russia to China to Turkey. The people of this region have a perfectly rational fear of paper

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money issued by the government, by government banks, or even by private banks subject to government regulation (allowing famous Western banks to issue gold-convertible private bank notes, as they do traveler's checks, would help overcome this crisis of confidence). Gold has long commanded respect in this area, and is widely hoarded. The influence of Islam, which is more comfortable with equity than interest payments, also plays a part. Any country with a gold-based money might well become a major financial center for the whole area.

Turkey May Try Free Banking

There is another option that would be much easier to implement than either a fixed exchange rate or official gold standard. This would be to facilitate the adoption of a parallel currency, which might soon displace rubles, by simply permitting the monetary use of gold coins and certificates. As a first step, a portion of the current gold stock, and of any additions to gold and/or foreign exchange reserves, could be used to mint coins denominated in troy ounces, half ounces, and one-tenth ounces. These coins would be auctioned to the general public for ruble currency, and the currency would be literally destroyed. Unlike recent issues of coins with a face value of 25,000 or 50,000 rubles, the coins should bear no face value in terms of rubles or any other artificial accounting unit—only a familiar measure of weight and purity. They would be "legal tender" in the sense that people could agree to set prices or make domestic and foreign contracts in ounces of gold, or gold-equivalent notes and bonds, and such contracts would be enforced by the CIS courts, and/or by binding private arbitration agreements.

Ideally, the legal system would also enforce contracts in dollars, marks, or any other currency. Russians can settle major commercial debts in hard currencies now, but they have to pay taxes in rubles. And open use of pricing in terms of foreign currencies is not fully sanctioned, or enforced by courts. Expecting the government of any major nation to give complete official sanction to the use of another country's money is probably unrealistic. It is simply too politically embarrassing—a confession of inferiority. It also would be unduly complex to quote prices in more than one or two foreign currencies—the higher information costs of having no single unit of account would offset one of the reasons that money is superior to barter. And adopting such foreign money also makes a gift of seignorage to the countries issuing the favored money (for example, Russians have to give up goods, services, or assets to acquire dollars, but Americans give up nothing in exchange if those dollars stay in Russia). For these reasons, a formal endorsement of currency substitution is much less

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likely to be a practical option than is allowing domestic gold coins and certificates to be used as an alternative money.

The next step after an initial issue of gold coins, which are granted full legal tender status, is free coinage and free banking (see Brough 1898, Dowd 1989). Free coinage means any new or hoarded gold could be brought to the mint to be coined, at a small charge. Free banking means private banks would be free to issue their own currency (bank notes) denominated in gold, subject only to a reserve requirement (and perhaps a minimum capital requirement on demand and time deposits). If the reserve requirement was as high as 100 percent, which is what has been suggested for a currency board, it is difficult to imagine what risks there could be in allowing any bank with such reserves to issue transferable gold certificates against them. Walter Bagehot (1873, p. 329), who was in some ways an early defender of central banking, nonetheless argued "that the natural system of banking is that of many banks keeping their own cash reserve, with the penalty of failure before them if they neglect it." Russia has a unique opportunity to listen to Bagehot, and avoid the horrible mistake that Britain made in 1946 by nationalizing the Bank of England, or that the United States made in the 1930s, by nationalizing the deposit insurance business.

A secondary reason for introducing free banking is to encourage the rapid development of financial intermediation, utilizing all the best liquid assets at the entire community's disposal including private hoards of gold and hard currencies. This would also tend to stem capital flight. Capital flight arises in part from absurd tax rates and insecure property rights, but also from the absence of domestic opportunities for savers. Free banking, along with mutual funds in privatized shares of enterprises (partly held by private pension funds), could greatly improve the ability to move funds from savers to those attempting to build new enterprises with equity and credit.

Turkey has announced a plan that appears to bear a striking resemblance to a gold-based free banking system—apparently as an alternative "parallel currency" to the Turkish lira. The idea could easily be adapted to Russia. Turkey plans to simply permit commercial banks to issue gold certificates against private deposits of gold, with those certificates providing transferable property rights to gold deposits. The proposed Turkish scheme could create a parallel gold standard—operating in a way similar to free banking with a 100 percent reserve requirement. It would not be surprising to see at least larger transactions being quoted in gold, and cleared with gold certificates, even as inflation of 60–70 percent continued in Turkish lira. An official with the Turkish Treasury is even quoted suggesting

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that such private gold certificates could "replace the Turkish lira" (Dorsey 1993). The advantage over de facto dollarization taking place in Turkey, as in Russia, is that such foreign use of dollars provides seignorage to the United States. It makes much more sense to instead mobilize and monetize domestic gold hoards.

A Parallel, Gold-Convertible Currency

To adopt the Turkish plan to Russia's more serious inflation, it would be particularly desirable to also put gold coins into circulation, as proposed above. That would make it easy to issue gold certificates in small denominations, which could be redeemed on demand in coin. Such a system could soon render the ruble obsolete, just as Russia's gold-backed chervonets gradually displaced fiat money in the 1920s, as part of Vladimir Lenin's New Economic Policy (NEP).

The chervonets was introduced as a second, alternative currency in July 1922, equal to 10 prewar gold rubles, or 7.74 grams of fine gold. New currency issues were limited by a requirement that they be matched by a gold reserve. In 1922–23, the Gosbank paid 4 percent interest rates on gold deposits, compared with 48–72 percent for fiat money, and also made loans calculated in terms of gold. Even before the formal stabilization in 1924, the Gosbank could lend chervontsi at interest rates of 8–15 percent, compared with more than 216 percent for loans in fiat money (Homer 1977, p. 545). Soviet gold reserves increased from $2.6 million at the end of 1922 to $45 million, $73 million, and $94 million in the following three years (Board of Governors 1976, p. 551). Until 1928, chervontsi could even be bought and sold on foreign exchange markets.

It was originally intended that the chervonets would also be convertible into gold. A memo from Lenin to his commissioner of finance requested proposals for the free circulation of gold (Nove 1986, p. 91). But that never happened. On February 15, 1924, the chervonets became the sole currency, and exchanged at the rate of one chervonets for about 50 billion 1921 rubles. By the time of stabilization, the price level in terms of the former currency (sovznak) had risen to 60 billion times what it had been in 1913 (Hirschleifer 1963, p. 27). There was an element of quasi-fixed exchange rates involved, in addition to the gold backing, as is the case with the reforms in Argentina and Estonia in the early 1990s. The government sent agents into the illegal foreign exchange markets to buy and sell the chervonets, and thus minimize possible depreciation of the currency (Anderson 1979, p. 420). Black market interest rates on short-term loans in Moscow dropped from 720 percent in 1922 to 72 percent in 1925, and rates fell steadily thereafter. Government

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10-year bonds sold for 8–10 percent. Overt inflation was moderate from 1924 until 1931, when the Gosbank was granted a credit monopoly.

There were important, supporting financial reforms in the USSR in the 1920s. The Gosbank paid 6 percent interest on demand deposits after 1927, and there were stock exchanges in the USSR from 1921 to 1930. Savings banks, begun in 1923, numbered 16,924 by 1928, and they protected savers from currency depreciation prior to the 1924 reform. Several hundred mutual credit societies provided capital to private enterprises, paying about 10 percent on deposits in 1927 and lending at 33 percent. Such financial liberalization along with vigorous economic growth from supply-side incentives were additional reasons why the NEP system, with its vigorous economic growth, stopped the hyperinflation. Some similar innovations in financial services may well be applicable to today's Russia.

Despite the historic and symbolic value of the chervonets, the current situation is not yet sufficiently similar to Russia's disastrous hyperinflation of 1917 to 1924—nor was the success of the late twenties sufficiently durable—to warrant total replacement of rubles with such a new "official" currency. Gold notes and coins could, however, easily serve as a parallel alternative. But as far as having a dual-currency system as existed in 1922–24—where a sound and worthless currency coexist until the former drives the latter out of use—that same function could be filled, with far more credibility, by simply allowing private financial transactions in gold coins and gold certificates, as Turkey now proposes to do. The government's only role in such a system is at most to certify that coins are genuine and to prosecute anyone circulating fraudulent coins or notes (counterfeiting is not a problem unique to private money, however). This is so simple a reform, with so much potential benefit, that it is difficult to imagine any reasonable objection to it. Free banking in gold certificates (as may happen in Turkey) is not something that has to be chosen instead of fixed exchange rates or other possible reforms. On the contrary, private gold certificates could certainly be combined with efforts to back the ruble with gold and foreign exchange (as in Estonia and Argentina), and to adopt a fixed exchange rate (as in Hong Kong) or a crawling peg (as in Mexico). The competitive discipline that such a parallel currency provides would tend to enhance the chances of successful stabilization of the ruble as well. If ruble stabilization continues to fail, the Russian people would have a readily available alternative (other than foreign money) to provide the important services that good money provides, greatly improving efficiency relative to primitive barter.

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If the ruble exchange rate can, in fact, be stabilized in terms of some hard currency, it can also be stabilized in terms of gold. In that case, having gold coins and certificates in circulation could make it quite easy to adopt a true gold standard, making the ruble literally "as good as gold." A stabilized ruble could simply be made convertible into gold certificates and coin at a fixed rate, through a currency board or similar institution. Such a gold-convertible money could easily become the most respected currency in the world.

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that could have been purchased with the stock of foreign currency being used for transactions purposes. With a currency board, where the domestic authorities stand ready to buy and sell foreign currency at a fixed price in relation to domestic currency and keep 100 percent of their reserves invested in foreign currency assets, the cost is reduced to the spread between the rate of return on the foreign exchange assets and the rates of return on the forgone domestic investment or consumption.

Because of this cost, one might conclude that a country can do better with a managed fiat currency. But history offers a depressing number of examples where discretionary monetary policy has led to disaster. Even in the best of circumstances, fiscal pressures, political considerations in general, as well as genuine uncertainty about what exactly is the best route to take to price stability, conspire to undermine the pursuit of sound money under a managed fiat currency system. Inevitably there is a trade-off between the implicit costs of a gold standard, for example, and the risks of runaway inflation with a managed fiat currency.

In order to transform its economy successfully, Russia needs, as Reynolds suggests, a sound money regime. However, during the transition from an economy fueled by expansionary fiscal and monetary policy to one based on the expansion of private industry, it is important to avoid a sharp contraction in economic activity. Reynolds is correct in emphasizing "supply-side tax policies."

In addition to this general point, I have a few specific comments on Reynolds' interesting and provocative paper. In the paper, the so-called ruble or monetary overhang is discussed briefly; the ease with which this overhang could be absorbed through the privatization of Russia's large stock of official domestic assets is noted. The price rises in connection with Russia's price liberalization effort at least temporarily removed some of this overhang as a source of concern for macroeconomic policy, albeit at the cost of high rates of inflation. I believe that it is important not to link mechanically the essential process of privatization with the monetary overhang. Regardless of the macroeconomic situation, it is important for the Russian authorities to get on with privatization, although how privatization is put into effect should be influenced by macroeconomic conditions.

Reynolds rules out the possibility of conducting monetary policy in Russia through the use of central bank open market operations in a government bond market. Such operations might well be difficult and perhaps ill-advised given the virtual nonexistence of sophisticated financial markets in Russia. After securing a sound money system, reform efforts need to be aimed at developing financial markets,

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A Gold-Based Monetary Policy for Russia

Wayne D. Angell

The Importance of Sound Money

Sound money in any country is important. It is particularly important in countries that are in critical need of new capital formation such as Russia and the other emerging market economies of the former Soviet Union and Eastern Europe. Sound money reduces the need for a risk premium on investments and therefore encourages a higher rate of capital formation.

Conditions are unsettled in Russia at this time. Sound money, by putting an end to inflationary conditions and by encouraging private investors, would help forestall a downward spiral in the Russian economy. Sound money also would help keep Russia from breaking up into different national groups by providing a sound common currency.

The Choice of a Monetary Regime

In his paper, Alan Reynolds rightly stresses the importance of sound money for the successful performance of an economy. However, what the reader may not appreciate from Reynolds' discussion is the fact that sound money is not an easy achievement in this environment; nor is it costless. Each of the major alternatives to managed fiat money entails a degree and type of seignorage loss. A commodity standard such as a gold standard involves government hoards of commodities. In the Russian case, if a gold coin standard or a gold bullion standard were chosen, the opportunity cost would be the explicit and implicit rates of return on the imports of both capital and consumer goods that could have been financed through gold sales. Simply adopting a foreign currency, say the U.S. dollar or the German mark, similarly entails forgoing the return on the imports

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including a government bond market. Alternative vehicles for open market operations, such as gold or foreign assets, perhaps could be best viewed as necessary during the transition phase. Their merits after a transition period might then be usefully reexamined.

In Reynolds' paper, the very interesting idea of minting gold coins with no set ruble (or any other currency) value is presented and discussed. I have no problem with such a marketing strategy for the Russian gold mining industry. Of course, Russia does not really need any domestic gold producers to have a gold coin system; all Russia needs to do is to stand ready to mint gold purchased at the world market price. In any scheme, however, the opportunity cost of the gold coins is sharply drawn: imported capital and consumer goods are forgone.

Indeed, the discussion of gold coinage leads into another interesting idea: free coinage and free banking in an economy in which gold coins, currencies issued by private banks, and currencies issued by domestic and foreign governments coexist and, in effect, compete as transactions media and financial instruments. All this may be exciting to some, but it seems somewhat visionary to me. What bothers me about this discussion is that I doubt if many advanced Western economies are sophisticated enough in their use of markets and in their acceptance and understanding of competitive forces to rely on free banking and competing currencies for their monetary arrangements and monetary policies. Surely the Russian economy, which Reynolds argues elsewhere in his paper is not sophisticated enough to support open market operations in government bonds, is not ready for this particular financial and monetary regime. Seventy-five years ago Russia was subjected to another untested economic theory intended to be applied to an advanced industrial economy. That experiment was a disaster. I do not think the Russians want to try another anytime soon.

I would like to conclude my discussion of Reynolds' paper by stating that I am in basic agreement with him: it is vitally important that Russia have a sound money right from the start of its transition to a free-market economy. However, in consideration of the difficult conditions now prevailing in the country, and the uncertainties of just how events will transpire in the future, I think it behooves us to make an effort to formulate what I would like to call an "error-tolerant monetary plan."

An Error-Tolerant Monetary Plan

The standard arguments against any fixed commodity price standard cite the risk to the economy of various external and internal

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shocks that alter the fundamental equilibrium relative price of the commodity or basket of commodities being used as the standard of value. Such shocks in a commodity standard regime force all of the adjustment onto the nominal prices (including nominal wages) of goods and services other than those serving as the standard of value. Depending on the shock and the underlying situation, this type of adjustment can be disruptive and costly. These arguments are no less valid in the Russian case. Moreover, the extreme uncertainties about the future course of the Russian economy now prevailing seem to magnify the importance that one should attribute to this particular line of reasoning. Of one thing we can be sure: the Russian economy in the near term is in for some shocks. The Russians therefore need an error-tolerant monetary policy.

I would suggest that the Russian authorities seriously consider adopting a gold price target for their monetary policy rather than a rigid link to the gold market or any other commodity market. Under such a regime, growth of the money stock would not be permitted unless the price of gold is below the target price so that the rate of expansion of the domestic money stock would be adjusted as appropriate depending on movements in the free-market price of gold. This approach would yield the stability of the general price level usually associated with a gold standard, but without the rigidity of the gold standard since the target could be missed if there were a danger of a severe contraction of economic activity. In light of the extraordinary situation in Russia, it seems important to stipulate that the money stock should never contract in order to force the price of gold back to its target price. Thus, there would be no danger of a run on Russia's gold stocks as gold sales would never be required.

Flexibility, of course, represents the potential for irresponsible discretionary policy actions. This risk exists in every policy regime to some degree. One cannot ever rule out the possibility that a sovereign government at some point will renounce any monetary regime, including a gold standard.

In order to start with a clean slate, it might be useful to introduce a new currency along with the new monetary policy regime, although strictly speaking it would not be necessary. The authorities eventually could use the market wages and other costs of production in the Russian gold mining industry as an indicator of the relative price of gold and of the suitability of their gold price target.

If the Russians did choose to introduce a new currency, nominal contracts would be switched over at a certain date. The government's obligations to holders of old rubles should be an important responsibility under the new regime. An even exchange at a rate of one to

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one between old rubles and the new currency would be one method, but considerations of the low current value of the ruble owing to an existing monetary overhang might argue for some increase in the value of the new currency. Expropriation by means of a graduated adverse exchange rate is another possibility. However, it would be preferable, and from a structural point of view desirable, to sell off "general equity shares" in state properties in exchange for rubles. The Russian government would decide what proportion of Russian assets to be privatized would constitute a fair return for ruble holders. Each subsequent privatization transaction would provide an opportunity to convert these "general equity shares" into specific property. Holders of the new currency would need to purchase "general equity shares" in order to buy state property. Hence there would be a new currency "general equity share" auction price and a fixed ruble price for "general equity shares," and therefore an arbitrage price between the new currency and rubles.

Some have advocated sales of gold-backed bonds as the sole means of removing surplus rubles. At this stage of Russian development, I am wary of such an approach. I would not want the Russian authorities to be placed in a position of making promises that they could not keep. Bonds must be serviced in full regardless of the country's economic circumstances. Equities, on the other hand, have a more suitable risk-sharing arrangement. If the economy experiences some bad outcomes, the holders of the equities share them with the general public; the Russian authorities need not choose between breaking their promise to service their bonds and raising taxes and/or selling off their gold reserves to keep their promise. Bonds, including gold-backed bonds, should be introduced only after the new currency has a demonstrated record of price stability. In my judgment, it is premature to make them the cornerstone of any new monetary policy regime.

There are two main benefits from a monetary policy based on a gold price target. First, as I have formulated it, the policy is flexible enough to be error tolerant. Second, the authorities can capture the seignorage revenues inherent in the provision of monetary services to the economy. Of course, as is well known, seignorage is tempting, particularly to governments with short planning horizons. However, the gold price target constrains the pursuit of seignorage. The gold price target regime is flexible, but not too flexible. An expanding economy will need an expanding money stock; monetary expansion aimed at keeping the gold price at its target level would achieve that objective.

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Compared with the gold standard, the gold price target regime is more flexible in the face of internal and external shocks and allows the financial benefits of seignorage to accrue to the government. But this proposed gold price target regime would not be so flexible as to allow a continued increase in the general price level.

With a currency board arrangement, much of the financial benefit of seignorage can be captured by the government. However, there are some inherent difficulties in currency board schemes. There is always the risk that the government might not stick to the rules. In some instances, of course, we might applaud this as sensible flexibility. But there is a downside risk as well, and private investors are sure to recognize it and build a risk premium into the interest rate on domestic investments. (Under a gold price target regime, there is also a risk that the authorities might not stick to the rules. In such a regime, the risk premium probably would be more likely to show up first in a rising gold price, which would halt money growth. Thus, there would tend to be a buffer shielding interest rates from the impact of "runs" on the system.) Moreover, there is the risk that the foreign currency or basket of currencies chosen as the standard of value is unstable or otherwise inappropriate. This risk is analogous to that under a commodity standard, except that it is heightened by the fact that governments rather than private markets are responsible for the supply of the standard of value, that is, the targeted foreign currency or currencies. A third problem with a currency board is that the stance of monetary policy is determined largely by the country's trade and capital flows, which seems to me to present some risks to macroeconomic stability that, at this stage, Russia would be better off avoiding.

Conclusion

I would like to close with two final observations that seem to favor a gold-based monetary policy over a foreign currency–based policy such as a currency board. Russia is a resource-rich country, similar to the United States. Linking the value of its money to the value of one of its main resources would appear to be a sound and sensible idea. Finally, since one can anticipate a healthy and profitable gold mining industry in a transformed market-oriented Russia, there is a potential link between wage costs and the market value of gold. This link would seem to me to be more reliable than any attempt to judge relative international values based on purchasing power parity considerations, as would be likely under a currency board arrangement.

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A Commodity Standard for Russia?

Anna J. Schwartz

The bottom line of Alan Reynolds' ruminations on economic conditions in Russia is that a commodity standard would be desirable not only there but in the Commonwealth of Independent States (CIS) as a whole. He states that the ruble or some other accounting unit, to be acceptable in international trade, must be literally convertible at home into either hard currency or hard metal on demand.

How Should Convertibility Be Provided?

In Reynolds' opinion, it is a seconary issue whether a currency board or a central bank is the agent that provides convertibility. Since he notes that central banks have earned little credibility, it would appear that currency boards win this contest. However, he disparages a currency board as a single monopoly issuer of currency, and appears to accept Annelise Anderson's argument for free banking in Russia, as if a currency board would be precluded under free banking. Presumably, free banks would not be currency issuers, if a currency board existed, but could otherwise operate as free banking advocates suggest.

The key question, as Reynolds notes, is how to hold the issuer accountable. For a currency board, its assets in gold or hard currency investments are a minimum of 100 percent of liabilities. For free bank currency issuers, Reynolds would impose similar asset requirements, explicitly ruling out assets in the form of debt issues of governments or state enterprises, but fractional reserves in his view would be adequate.

Another reservation Reynolds expresses with respect to a currency board is that fixing the ruble to a more credible foreign currency, such as the dollar, would not work in Russia because the board could not rely on a regular flow of dollars through trade surpluses or net capital inflows to permit expansion of the currency supply as economic

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activity increased. Moreover, even if the Russian economy were vigorous enough to run current account deficits, they would likely be matched with illiquid capital inflows. Its capital markets are too undeveloped, he asserts, to provide a reliable source of liquid foreign exchange to serve as backing for currency board money. Reynolds' pessimism is not based on historical experience with currency boards.

Moreover, he may be extrapolating existing trade patterns to validate his concern that Russia would generate only small and variable trade flows, and projecting current capital market underdevelopment into the future. His own blueprint for the monetary system, however, envisages the spread of financial intermediaries. And I see no reason, if gold mines and the oil and gas industries are privatized, why their owners would not sell their output to foreigners and thus acquire foreign exchange that they would transfer to a currency board for local currency.

So Reynolds opts, instead of foreign currency backing for Russian money, to redeem rubles in gold, since the country has gold mines. Some of his doubts that currency board reserves would expand with economic growth may also be raised with respect to gold backing, as I note at a later point, although he does not raise such doubts.

A Commodity Basket versus Gold

Reynolds dismisses relying on commodity baskets instead of a single commodity on the ground that "there are very few commodities [other than gold] that could function well as money, or as monetary reserves." He goes on at some length to defend the gold standard against the charge that it was associated with short-term price instability. The issue Reynolds does not confront is that it is unanticipated changes in the demand for and supply of a single commodity standard that produce price level instability. The advantage of a commodity basket is that technologically induced changes in relative costs of production of some components of the basket would not be correlated with such changes affecting other components in the rest of the basket.

Under a gold standard, a change in the cost of production of gold can occur either because of a change in mining techniques or because of a change in technology affecting the production of other commodities. Improved techniques of mining or the discovery of new mines will reduce the cost of production of gold below its current price, stimulating gold output. Gold money will increase at a greater rate than required to maintain stable prices of other commodities. Their

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prices will rise and so raise the cost of gold production. Gold output will be discouraged and the rate of increase of gold money will fall back.

Similarly, a decline in prices of goods and services, due to technological improvements in the nongold sector, will make gold output more profitable, increasing coinage of gold, which will ultimately raise prices of those goods and services and reverse incentives to increase gold output. The effects of changes in demand for gold money on the supply of gold need to be taken into account as well as the effects of changes in the price of gold as money relative to the price of gold for other uses. Shifts in demand between industrial and monetary use, however, have corrective output effects that produce long-run price stability.

The time frame in which the automatic corrective forces operate may, however, be prolonged. The annual flow of new gold adds only a small fraction to the stock accumulated over centuries, hence even a modest rise in the stock demand for gold may take years to be achieved, and meanwhile the price level will be depressed. Similarly, an increase in the growth rate of the economy will require a larger flow of new gold, necessitating a higher price for gold relative to other goods. Deflation of their prices will tend to result.

Reynolds proposes coining half of Russia's gold hoard and half of any later additions to gold reserves and auctioning coins denominated in troy ounces for rubles that would be destroyed. He suggests using official gold stocks as backing for gold bonds, with gold earmarked for redemption in a secure foreign country, but regards this use as inferior to introducing gold coins, which would serve as money alternative to rubles.

Following the initial issue of gold coins, the mint would coin new or hoarded gold at a small charge. Private banks would be free to issue currency and deposits denominated in gold, rubles, any republic's currency, or a monetary unit defined by the government as a weight of gold. Banks might be required to maintain fractional or 100 percent reserves in the currency they hold as assets. Competing private insurance companies could offer deposit insurance. In this way financial intermediation would expand.

Monetary Blueprints for Russia

Reynolds offers two blueprints for the monetary system alternative to the gold standard. One revives proposals by Lamanski, a deputy governor of the Bank of Russia in 1861, to make the government-controlled central bank a private institution, to sell state assets to end budget deficits, and to issue currency only against increases in gold or

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hard currencies. Another alternative revives the gold-backed chervonets, introduced in 1922 as a currency in competition with depreciated rubles, that would be convertible into gold. That never happened, and in 1924 the chervonets became the sole currency, exchanging at the rate of one chervonets for 50 billion 1921 rubles. Inflation subsided from 1924 until 1929. However, Reynolds believes the current situation in Russia is not comparable to the 1917–25 hyperinflation, and hence does not warrant abandoning the ruble.

Finally, Reynolds rejects the view that only an authoritarian regime could institute a gold standard in Russia because the reform would impose costs that the public would not otherwise tolerate. I agree that the public would not find burdensome a change in regime that eliminates the costs of hyperinflation, and that a gold standard might win a favorable public response. I doubt, however, that that is the course that Russia will follow. Just as Russia opted for the gold standard in the 1890s because that was the choice of modern industrialized countries, it will in the 1990s opt for a discretionary central bank that is the hallmark of today's industrialized world, however misguided the choice.

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Currency Boards and Currency Convertibility

Steve H. Hanke and Kurt Schuler

Standard textbooks characterize the evolution of an economy toward a modern market economy in the following way. Initially resources are privately owned but there is no money, so trade takes the form of unorganized barter. That is extremely costly and inefficient because it requires a double coincidence of wants. The high transactions costs that result are a barrier to any trade taking place at all.

To reduce transactions costs, economic agents attempt to organize barter. Marketplaces develop, with trading grounds divided into trading posts or stalls at which specified pairs of commodities can be traded. Typically, these markets will be open for trade on specified market days. Even such organized barter is very costly, however. For example, the pairwise trading of only 10 commodities requires 45 separate trading stalls.

To further reduce costs, economic agents attempt indirect pairwise trading. That can be accomplished by establishing trading posts for all commodities except one, the exceptional commodity being distinguished from all others by the fact that it is tradeable at all posts. The exceptional, intermediary commodity is money. Money facilitates the development of a modern market system by lowering the costs of acquiring information and making transactions (Brunner and Meltzer 1971).

Now, let us turn our attention from the textbooks to the former Soviet Union. At the very time when the former Soviet Union claims

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that it wants to move toward a market economy, it is regressing toward unorganized barter. The cause is its dysfunctioning money, the ruble, which is inconvertible externally and, to a large extent, internally. If the former Soviet Union wishes to establish a modern market economy it must introduce a sound, convertible currency.

The Functions of a Sound Currency

A sound currency serves as a satisfactory store of value, medium of exchange, and unit of account. An unsound currency such as the ruble does not fulfill any of those functions. An unsound currency is not a reliable store of value because inflation makes its value highly unpredictable. As a result, people save by hoarding bricks, timbers, food, and other commodities, which retain value better than money and other financial assets. Although commodity hoarding is rational for people in the former Soviet Union at present, it withholds resources from production and slows economic growth.

An unsound currency such as the ruble is not a good medium of exchange. The outside world refuses to accept it. That impedes much-needed Western investment in the former Soviet Union. The inconvertible ruble also impedes foreign trade, which is needed to provide competition with monopolized enterprises and to establish an internationally competitive structure of prices for tradable goods and services within the former Soviet Union. The ruble is not even a good internal medium of exchange within the former Soviet Union. Consequently, barter is common, and almost all transactions for exchanges of large real property are priced and take place in foreign currency (Uchitelle 1992a). Lack of external and internal convertibility slows economic growth.

An unsound currency is not a good unit of account. Inflation distorts prices and makes business calculation more difficult. Without a reliable unit of account, it is impossible to make accounting calculations, to write contracts, and to make meaningful economic decisions. Indeed, without a reliable unit of account, the information that is contained in market prices is lost and the means of efficient communication ceases. A novelist captured this point when describing the German hyperinflation: "Money was rapidly ebbing away from between men, leaving them desperately incommunicado like men rendered voiceless by an intervening vacuum; millions, still heaped on top of each other in human cities yet forced to live separate, each like some solitary predatory beast" (quoted in Scitovsky 1969, p. 2).

The ruble is being issued by a central bank that possesses little, if any, credibility. Citizens of the former Soviet Union have responded to the ruble's untrustworthiness by conducting their own unofficial

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monetary reform, substituting foreign currencies for the ruble (dollarization). Flight from the ruble has been significant: it is estimated that households in the former Soviet Union hold $5 billion to $10 billion in hard currency (Dempsey 1992, Hanke 1991, Norman 1991b). Indeed, the real value of hard currency holdings by households exceeds the real value of the total ruble supply.

Dollarization is costly. To obtain dollars or other "hard" currencies, citizens of the former Soviet Union must exchange real goods and services for bits of paper that Western central banks produce at almost no cost. Moreover, once obtained, those bits of paper lose value over time. They generate significant profits for Western central banks, resulting in a perverse form of foreign aid that flows from the former Soviet Union to the West (cf. Fischer 1982).

The Currency Board Solution

As long as the former Soviet Union retains a central bank (or establishes new central banks), the ruble will continue to deteriorate, motivating more barter and dollarization. If the former Soviet Union wishes to transform its economy, it must stop relying on central banking. It requires an alternative to central banking. The currency board system is an alternative well suited for the former Soviet Union.[1]

We now present a proposal for introducing the currency board system in the former Soviet Union. We go into some detail because little information about currency boards is easily accessible, and because few people know how to establish and operate currency boards. In addition to presenting our proposal, we answer some questions that have been raised about currency reform for the former Soviet Union.

A currency board is an institution that issues notes and coins convertible into a foreign "reserve" currency or commodity at a fixed rate and on demand. It does not accept deposits. As reserves, a currency board holds high-quality, interest-bearing securities denominated in the reserve currency (or commodity). A currency board's reserves are equal to 100 percent or slightly more of its notes and coins in circulation, as set by law. (Commercial banks in a currency board system need not hold 100 per cent reserves in reserve-currency assets against their deposits, though.) The board generates profits

[1]Other economists who have recently voiced support for currency boards in the former Soviet Union and Eastern Europe include Milton Friedman (1991), Daniel Gressel (1989), Robert Hetzel (1990), Jerry Jordan (1991), Allan H. Meltzer (1991), George Selgin (1992), and Sir Alan Walters (1991). For more detail on the currency board system, see Hanke, Jonung, and Schuler (1992, 1993).

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(seigniorage) from the difference between the interest earned on its reserve assets and the expense of maintaining its note and coin circulation (liabilities). It remits to the government all profits beyond what it needs to cover its expenses and to maintain its reserves at the level set by law. The currency board has no discretion in monetary policy; market forces alone determine the money supply, where the money supply is defined as the public's holdings of notes and coins plus deposits held with the commercial banking system.

The main characteristics of a currency board are as follows.

Convertibility

The currency board maintains unlimited convertibility at a fixed rate of exchange between its notes and coins, on the one hand, and the reserve currency (or commodity), on the other hand. Although the currency board does not convert local deposits denominated in its currency into reserve assets, the exchange rate that it sets will determine terms of arbitrage between the reserve currency and local deposits at commercial banks.

Reserves

A currency board holds reserves adequate to ensure that even if all holders of the board's notes and coins (liabilities) wish to convert them into the reserve currency (or commodity), the board can do so. Currency boards have usually held reserves of 105 or 110 percent of their liabilities, so that they would have a margin of protection in case the interest-earning securities that they held lost value.

Seigniorage

Unlike securities or most bank deposits, notes and coins do not pay interest. Hence notes and coins are like an interest-free loan from the people who hold them to the issuer. The issuer's profit equals the interest earned on reserves minus the expense of putting the notes and coins into circulation. These expenses are usually less than 1 percent of assets per annum. In addition, if the notes and coins are destroyed, the issuer's net worth increases, because liabilities are reduced but assets are not. Seignorage generated by a currency board is significant.

The chief economic difference between using currency issued by a currency board rather than reserve currency notes and coins is that a currency board captures seigniorage for domestic use, rather than letting it accrue to the foreign central bank that issues the reserve currency. A currency board also has the political advantage of satisfying nationalistic sentiment for a local issue of currency.

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Monetary Policy

By design, a currency board has no discretionary powers. Its operations are completely automatic, consisting only in exchanging its notes and coins for the foreign reserve currency at a fixed rate. Unlike a central bank, a currency board cannot act as a tool of inflationary government finance; nor can it offer state-owned enterprises credit at below-market interest rates to accommodate a "soft budget constraint," because a currency board cannot issue fiduciary money. Under a currency board system, government expenditures can only be financed by taxing or borrowing.

Interest Rates and Inflation

Given the fixed exchange rate between the local currency and the reserve currency, interest rates and inflation in the currency board country will tend to be roughly the same as those in the reserve-currency country.

Historical Record

The currency board system is a well-tried system with an excellent record (Schuler 1992). It has existed in over 60 countries, and in all cases maintained convertibility at a fixed exchange rate. Even though currency boards performed well, most currency boards fell victim to intellectual fashions of the 1950s and 1960s that favored central banking. Also contributing to the demise of currency boards was the unjustified stigma of colonialism that attached to them in many former British colonies. Former colonies tended to rid themselves indiscriminately of previously existing institutions, throwing the baby out with the bathwater in the case of currency boards. Today, orthodox currency boards still exist in Hong Kong, Brunei, the Falkland Islands, the Faroe Islands, and Gibraltar.

Among the nations that have had currency boards is Russia. The region around Archangel and Murmansk had a currency board in 1918 and 1919, during the life of an anti-Bolshevik government in the region. The board was the idea of John Maynard Keynes (Hanke and Schuler 1991b). It issued a very successful, stable ruble currency redeemable at a fixed rate of 40 rubles per £1 sterling. Its currency circulated parallel to the inconvertible, unstable currencies issued by other Russian governments at the time. The board's sterling-backed ruble drove the others out of circulation because it was preferred by inhabitants of the region. The experience of North Russia may appear to contradict Gresham's law that "bad money drives out good." However, Gresham's law only holds when the law sets an exchange

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rate that favors the bad money. When exchange rates are determined freely, good money tends to drive out bad money (Brunner and Meltzer 1971).

Like the North Russian currency board system, other currency board systems had excellent records. No currency board ever failed to maintain convertibility at the fixed exchange rate with its reserve currency. Currency boards in North Russia and Burma even managed to maintained fixed rates during civil wars. Most currency board countries accommodated money supply growth and strong, noninflationary economic growth. For example, in Hong Kong, average annual growth in real gross domestic product per person was 6.3 percent from 1965 to 1989. Moreover, Hong Kong maintained relatively low inflation in that period.

Establishing a Currency Board

In a number of cases, including the free city of Danzig, Palestine, and Libya, currency boards have replaced central banks or other monopoly note issuers. However, the case we present is one in which a currency board comes into existence as a parallel issuer of currency, as it did in North Russia. Hence the currency board's currency may circulate competitively against that of a local central bank or of a foreign central bank (as other former Soviet republics now consider the Russian central bank to be). (In Hanke and Schuler 1991c, we discuss both scenarios in detail.)

The steps in establishing the currency board are as follows.

1. The currency board statute is established. (See Hanke and Schuler 1991c, Appendix I for a model statute.)
2. The initial reserves are transferred to the currency board, which we proposed should be a private, not a government, institution.
3. The currency board issues no more currency than the amount of its initial reserves. Hence, the board's currency is backed by 100 percent reserves from the start.
4. The new currency is put into circulation, preferably by a distribution to every citizen according to a predetermined formula.
5. All restrictions on foreign exchange and the entry by foreign financial institutions into the former Soviet Union are abolished.
6. The currency board's currency circulates as a parallel currency and competes with the currency of the local central bank; the exchange rate between the two currencies is freely determined.
7. The currency board stands ready to perform its sole function of exchanging its currency for reserve assets at a fixed rate.

Let us consider the most important questions about these steps.

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Step 2: Where can the reserves be obtained? State property should be used to supply the initial reserves. That should not prove to be difficult: the Communist Party and state-owned enterprises in the former Soviet Union deposited $15 billion to $40 billion in hard currency overseas in 1991 alone (Dempsey 1992). In addition, revenues from sales of state-owned assets in the former Soviet Union could be used for reserves.

Step 3: How large should the initial reserves of the currency board be? Establishing currency boards in the former Soviet Union would not require enormous foreign reserves. This is particularly the case since we propose to issue a new parallel currency in each former republic that wants one, rather than to replace an old currency with a new currency. In any case, under the currency board system the actual size of the initial reserves is not crucial, because the system allows the supply of new domestic currency to adjust readily to demand.

To appreciate how small the initial reserves could be, suppose a new currency board in the former Soviet Union were to distribute the equivalent of $15 to each citizen. Although $15 does not appear to be much at first glance, it exceeds a month's wages for the average worker at present market exchange rates. Since there are about 275 million persons in the former Soviet Union, the total amount needed to provide 100 percent reserves for new currency boards would be just $4.1 billion. Past currency reforms that *completely* replaced an old currency with a new (such as the German reform of 1948) were able to restart economic activity by using similarly small amounts of new, sound money.

Step 4: How should the currency board's notes be distributed? The exchange rate between the currency board currency and the reserve currency should be one to one, so as to make conversions easy to calculate. (This is merely a matter of convenience. If the exchange rate is, say, 135.33 currency board rubles per U.S. dollar, the nominal amount of currency board notes will be 135.33 times greater than if the exchange rate is one currency board ruble per U.S. dollar. The real amount of currency board notes, calculated in dollars, will be the same in both cases.) The currency board should start the new monetary system by distributing notes and coins representing 100 percent of the value of its reserves. If it has $4.1 billion in reserves, it should distribute the equivalent of $4.1 billion worth of its notes and coins. The actual distribution could be designed in various ways. The easiest method would be to give every citizen or household an equal, one-time gift of the new currency. In addition to simplicity, this type of broad-based distribution of the new currency would be

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popular, and would motivate support for the currency reform, popular capitalism, and a transition to a market economy (Piñera 1991).

Step 5: What restrictions on foreign exchange and foreign banks are necessary? None. Without restrictions on foreign exchange, currency competition can exist, not only between the issues of the local currency board and the local central bank, but also with foreign currencies (Hayek [1976] 1991). With the freedom to hold and conduct transactions in any currency, good money will drive out bad, resulting in the sound monetary system that is a necessary condition for a successful transition to a market economy.

To make the currency board system yield its full benefits, foreign commercial banks should be allowed free entry into the former Soviet Union. Existing banks in the former Soviet Union lack the credibility that foreign banks possess. In addition to bringing credibility to the banking system, foreign banks will bring with them new techniques and knowledge about financial matters (Uchitelle 1992b).

The currency board system and free entry of foreign branch banks will allow for the natural establishment of commercial ties with the reserve-currency country, because foreign exchange risk for persons in the reserve-currency country who invest in the currency board country and make transfers of capital will be eliminated. Foreign branch banks have always been common in currency board countries. This has given those countries ready access to international capital markets and expertise. The presence of foreign branch banks has made for a more vigorous commercial banking sector in currency board countries (Hanke and Walters 1991).

Step 6: What will be the fate of the currency issued by the central bank? The currency board's notes and coins will enter into circulation alongside the central bank's notes and coins. If the central bank ruble remains an unsatisfactory currency, much of the economy will quickly switch to the currency board ruble as the unit of account because it will be far more stable than the central bank ruble. It will be a matter for individuals and enterprises to decide which currency they wish to use.

If the currency issued by the central bank continues to suffer from high inflation, it will eventually cease to be widely used. That is what occurred in North Russia after local currency board notes were introduced in parallel with the inflationary issues of other Russian governments fighting the civil war. That was also the experience in the Soviet Union from 1922 to 1924, when the nominally gold-backed chervonets circulated in tandem with the depreciating sovznak (Yeager 1981).

As the public becomes convinced that the monetary reform is working, it will deposit its hard foreign currency in local bank

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branches. People should be free to convert foreign currency into domestic currency or to hold the deposits in any foreign currency they wish. Permitting foreign currency deposits will promote financial development, as it has in Hong Kong, where foreign currency deposits exceed Hong Kong dollar deposits.

Step 6 (continued): What will be the effects of the currency board on wages and prices? The currency board is based on a fixed rate of exchange with the reserve currency. Using this rate as an anchor, nominal wages and prices within the currency board country must be set accordingly. No one can know in advance what the proper wages and prices should be; thus we cannot give any recommendations on "correct" wages and prices. Market forces should be allowed to set wages and prices freely. The new currency would facilitate the process, though. Some wages and prices will temporarily be set at inappropriate levels, but trial and error in the market will tend to make mistakes self-correcting.

As a first approximation, wages and prices can be translated into their levels in the reserve currency. Thus, if a farmer sells potatoes for 15 rubles per kilo, the floating exchange rate of the ruble is 100 rubles per U.S. dollar, and the fixed exchange rate of the currency board currency is one currency board ruble per U.S. dollar, the price of potatoes should be 0.15 currency board rubles per kilo. (Remember that the currency board ruble has a fixed exchange rate with the U.S. dollar in this example, but it floats against the central bank ruble unless the central bank fixes the ruble to the U.S. dollar also.) As confidence in the new monetary system increases, wages and prices will probably require substantial adjustment from their initial levels. The government should not interfere with price adjustments by imposing mandatory indexation or price controls on the private sector. Such interference will result in an inflexible economy that is incapable of adjusting to changing market conditions (Luders and Hanke 1988).

Operating a Currency Board

A currency board is simple to operate. Past currency boards have usually had staffs of 10 or fewer people. They have been able to achieve economies by contracting some clerical and investment functions to outside parties. Indeed, most currency boards have used large commercial banks in the countries where they deposited their assets as agents. One of the great advantages of a currency board is its extreme simplicity. It is doubtful whether the former Soviet Union has enough well-trained people to staff a central bank. We shall now describe the basics of operating a currency board.

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Exchange Policy

The sole business of the currency board will be to stand ready to exchange its notes and coins on demand at a fixed rate into or from the reserve currency at its offices. To hold a large stock of reserve currency notes and coins would reduce its profits, because the board would not be able to invest those funds in interest-bearing securities. The board should try to do a "wholesale" currency exchange business with commercial banks. However, the public as well as banks should be able to deal directly with the currency board. Some British colonial currency boards dealt only with banks, as a way of reducing their need for staff. It seems unnecessary and unjust to discriminate against the public in such fashion. Most people will exchange currency through banks in any case. Accepting transactions from the public introduces a form of competition with banks, and ensures that their fees for exchanging into the reserve currency will be low, thus tightening the link with the reserve currency.

The currency board should preferably not charge any commission for its exchange services, and should have no lower limit for exchanges. (By nature a currency board has no upper limit for exchanges, unless the public converts all of its notes and coins into reserve currency.) The purpose of a currency board is to costlessly eliminate exchange-rate risk between the board's currency and the reserve currency. Accordingly, there is no point in erecting barriers to exchange with the reserve currency. The social benefits of not charging commissions far outweigh the pecuniary benefits to the board of charging commissions. The board will earn a return on its assets in the form of interest from reserve-currency securities, which will easily cover all costs of operations.

Offices

The board should have a main office in Moscow, and perhaps a few branch offices in other large cities. The role of the branch offices or agents will be mainly to serve as places for safekeeping currency. It is not necessary to have actual branches. Instead, a commercial bank could act as the board's agent, as the Bank of British West Africa did for the West African Currency Board. The board should perhaps also have an office in the reserve-currency country to handle business there.

Management

The currency board should have a small board of directors—past currency boards have had three to eight directors—to oversee the

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board's managers. The powers of the board of directors and of the managers will be quite limited. Unlike their counterparts in central banks, directors will have no influence over monetary policy. (Later we will suggest how board members should be chosen.)

Staff

The currency board's staff will perform two functions: exchanging its notes and coins for reserve currency (and vice versa), and investing its assets in high-grade reserve-currency securities. The exchange work requires only a small staff of bank tellers. The investment work requires some expert financial traders, but since the board will follow rather routine, conservative investment practices, its expenses should be smaller than those of commercial banks with portfolios of similar size.

Reserves

The board should hold its reserves in high-quality bonds denominated in reserve currency. (Later we will explain how this rule could be modified.) It should not hold assets denominated in local currency, because that would open the way to central banking–type operations. Specifically, commercial bank reserves could be altered by changing the proportion of local currency assets to foreign currency assets held by the board. Besides opening the way for central banking, holding local-currency assets also could expose the currency board to defaults engineered by the domestic government.

It may be desirable to specify in the currency board's charter or by-laws what types of assets it could hold and what the maximum maturity would be. Long-term fixed-rate bonds swing widely in value as interest rates change, although they may offer higher average returns. Some past currency boards that invested heavily in long-term bonds suffered large losses when interest rates in the pound sterling rose sharply because of speculation against sterling, though their additional reserve of 10 percent prevented their reserve ratio from falling below 100 percent.

Past currency boards often divided their investments into a "liquid reserve" and an "investment reserve." The liquid reserve, consisting of securities that had maturities of less than two years, was typically about 30 percent of total reserves. The investment reserve, consisting of securities with longer maturities, made up the rest of the total reserves, equivalent to an estimate of the public's minimum, "hard-core" demand for a board's notes and coins. Liquid reserves should probably exceed 30 percent at the start, although it may be possible to reduce the ratio as time goes by.

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Expenses

Judging from the experience of past currency boards, expenses should average no more than 1 percent of total assets, and may be as low on average as 0.5 percent of total assets. The main expense will be printing notes and minting coins. Salaries will be the next greatest expense, and rent, utilities, and remaining costs will be small.

Protecting the Currency Board

Although the currency board system was a great economic success, most currency boards have disappeared because they lacked the political independence to prevent them from being converted into central banks. Suspicion that a new currency board might be reconverted into a central bank would undermine the board's credibility, defeating one of the main advantages of the currency board system. To strengthen its credibility, a currency board in the former Soviet Union could undertake the following actions.

The currency board should insulate itself from any possible government manipulation. The majority of the board of directors could be appointed by foreign governments or foreign private institutions. Precedents for such an arrangement exist. For example, only three of the eight directors of the Libyan Currency Board of the 1950s were Libyan nationals; the rest were British, French, Italian, and Egyptian nationals chosen by their respective governments.

The currency board could also keep its assets in a safe-haven country such as Switzerland, and could be incorporated as a private entity under the law of the safe-haven country, independent of the governments of the former Soviet Union. (Their permission would of course be necessary for the board to operate on their territory.) The Burmese and Jordanian currency boards, among others, had their headquarters in London even after Burma and Jordan became independent.

Another way for the currency board to strengthen its credibility would be for its notes to contain a statement that they are convertible into the reserve currency at a whatever fixed rate had been established.

The currency board's notes should be printed outside of the country where the board operates, and should be of high quality to protect them from being counterfeited.

Why Not a Commodity-Backed Currency?

Some economists argue that to obtain credibility, the ruble should be convertible into gold or some other commodity (Angell 1989,

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Wanniski 1990). That may indeed be the case, particularly in the southern republics of the former Soviet Union. A commodity-backed currency board is possible. In the past, most currency boards have used a single foreign currency as their reserve currency. However, some currency boards have held gold or silver along with foreign-currency securities as assets.[2] Since no well-developed loan market for physical gold and silver existed, their gold and silver reserves paid no interest. The boards earned less seigniorage than boards that held foreign-currency securities only.

Today, with new markets and financial products, the seignorage opportunity costs of using gold or other commodities as reserve assets for a currency board would be less than in the past. A currency board whose reserve asset was gold could lend the gold on the London gold loan market at the prevailing interest rate, currently about 2.8 percent a year.

Other commodities or a basket of commodities could also be used to back a currency issued by a currency board. Since organized loan markets for other commodities do not exist, the opportunity costs of using them would even be higher than using gold. Since nominal rates of interest from gold loans are lower than the rates presently available on securities in the leading hard currencies and since other commodities do not yield interest, a currency board that uses a commodity backing would earn less seigniorage than a board that uses a foreign-reserve currency. The credibility that might be gained by using commodities as reserves may exceed the seignorage lost, however. If so, commodity reserves should be considered for the currency board.

Why Not Free Banking?

Some have argued that the way to supply sound, convertible currencies in the former Soviet Union is to introduce a free banking system (Anderson 1992). Free banking is the system of banking without severe legal restrictions; in particular, it implies competitive note issue and decentralized reserve holding. Free banking existed in approximately 60 countries during the 19th century and the early 20th century (Dowd 1992). No free banking systems exist today, but free banking is enjoying an intellectual revival as an alternative to central banking.

The most important requisite of stable free banking is strong, competitive banks. Decades of socialism have left the former Soviet

[2]Examples include Mauritius (1849–1934), which held silver coins; New Zealand (1850–56), which held gold and silver coins; and Kuwait (1961–69), which held gold bullion.

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Union with no real bankers and bankrupt large banks. Indeed, virtually all banks are burdened by large portfolios of bad loans. Even if the banks are recapitalized or split into "good" and "bad" banks, or if inflation reduces their assets and liabilities to near zero, they will be weak for some time to come (Uchitelle 1992b).

As we argued above, a solution to the problems of the local banking system would be to allow reputable foreign banks to enter the market without restriction, either to buy local banks or to set up new competing branch networks. In free banking systems in some Latin American nations, the Caribbean, and British colonies, foreign banks provided great stability and keen competition. However, these systems arose over extended periods of time, not overnight (see Dowd 1992). If free banking were permitted today in the former Soviet Union, it would initially be characterized by feeble competition among poorly capitalized local banks; the banks would be managed by persons with no experience in banking in a market economy; and the banks would be operating in an environment in which few people trust local institutions.

Such a free banking system would be disastrous. No system of checking accounts and check clearing exists yet in the former Soviet Union, so currency has a greater role in business and personal payments than it does in the West. If no unquestionably reliable domestic currency existed, a few failures by so-called free banks would turn public opinion against competitive note issue and would make it impossible to achieve true, mature free banking, which is characterized by a small number of well-capitalized banks having extensive branch networks, competing with one another nationwide.

The present currency regime makes it too risky for foreign (or domestic) banks to try to establish branch networks in the former Soviet Union. However, if history is a guide, under a currency board system, well-capitalized private banks (most likely foreign-owned), with extensive branch networks, would develop in a relatively short period of time. Once a currency board made the currency regime stable, it would be possible for sound banks to become established and to eventually issue competing parallel currencies along lines envisioned by F. A. Hayek ([1976] 1991) and Roland Vaubel (1978). The currency board would not preclude such an evolution. Indeed, a currency board system would provide the type of stable currency regime required for the development of a free banking system.

Competition between currency board notes and bank-issued notes has occurred before. In the British Caribbean colonies, banks issued notes not subject to any special reserve requirements. Bank notes

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competed with currency board notes until the 1950s, when local governments outlawed bank note issue to gain more seigniorage revenue for themselves.

Whether the currency board would continue to exist after a mature free banking system developed would depend on whether consumers wanted to continue holding its notes and coins. If they did not, the board's note and coin circulation would decline toward zero as competing issuers gained circulation. Because the board would have 100 percent foreign assets, it would easily be able to meet competing issuers' demands to redeem its notes and coins. The board would fade away after having served as a bridge between central banking and free banking.

Why Not a Central Bank?

To date, most persons have blindly assumed the desirability of central banking for the former Soviet Union. (A notable exception has been Paul Volcker 1990.) The new nations formed from the wreckage of the Soviet Union are busily planning to establish their own central banks, and the Bank of England and the Bank of France are training aspiring central bankers (Norman 1991a).

It is extremely unlikely, however, that a standard type of central bank will provide a credible currency in the former Soviet Union. After all, central banks are responsible for the dire condition of the ruble and the weak condition of all other East European currencies. We who live in Western nations, most of which have relatively good central banks, tend to forget how rare good central banks are. Western central banks are the star pupils of the class. They produce convertible currencies that depreciate "slowly." However, for most of the 99 nations that the World Bank classifies as low- and middle-income, central banks produce inconvertible, unsound currencies. For example, in those nations, average annual inflation was 16.7 percent from 1965 to 1980 and 53.7 percent from 1980 to 1989.

To issue a fiat currency that functions properly, a central bank must possess credibility. That will be difficult in the former Soviet Union. For one thing, its historical experience does not inspire hope. Russia has had a government currency issue since 1768, and a central bank since 1860. However, it has had a fully convertible currency for only 35 of those years. The last year of convertibility was 1914. After that, Russia had something approaching sound money only from 1922 to 1924, in the early days of the chervonets currency. A sound, convertible central bank currency is not part of the Russian culture or memory.

Furthermore, the recent behavior of the Soviet (now Russian) central bank behavior has made most citizens distrustful of the ruble.

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In early 1991, 50 ruble and 100 ruble bank notes were demonetized. Most persons holding 50 ruble and 100 ruble notes were able to exchange them for an equivalent amount of smaller denominated rubles, but 10 billion to 12 billion rubles were confiscated by officials who determined that they had been obtained through "speculation" and other illegal means (Peel 1991).

In addition to a bad memory and mistrust of the central bank, citizens in the former Soviet Union and other post-communist nations have little trust and confidence in any government institutions (Engelberg 1992). A distinctive feature of the communist regimes was the overall mistrust that penetrated all relationships in society. The relationships among authorities and economic agents have been ones in which each has attempted to mislead the other with false and biased information (Major 1991). With decades of low credibility and mutual irresponsibility of authorities and economic agents, it is hard to imagine that that conditioning can be overcome quickly and credibility established at a central bank. Without credibility, a central bank will lack a necessary condition for the establishment of a sound, convertible currency.

Many believe that once Russia and other former Soviet republics join the International Monetary Fund (IMF), the credibility problem will be solved. That is a false hope. Let us look at recent experience of Yugoslavia, which has been a member of the IMF since 1945. The experience of Yugoslavia shows that, in an environment that has many similarities to that in the former Soviet Union, good behavior, credibility, and sound money have proved as illusive as the holy grail (Hanke and Schuler 1991a).

In December 1989, the monthly inflation rate was 50 percent in Yugoslavia, and for the entire year it had been 2,720 percent. Armed with an IMF stabilization plan, Yugoslavia introduced a currency reform in December 1989. It established a "hard" pegged exchange rate of seven dinars per German mark. To maintain the peg under conditions of low credibility, real lending rates were about 40 percent and real deposit rates were about 25 percent per year in most of 1990. Although inflation came down in Yugoslavia during 1990, the rate remained much higher than in Germany. Hence, the dinar became grossly overvalued and the Yugoslav economy slumped into a deep depression. Eventually, Yugoslavia had to give up on the hard peg and inflation soared (see Silber 1992).[3]

[3]For information abou tthe scandals afflicting the National Bank of Yugoslavia in 1991 and 1992, see Ernsberger (1992), Sudetic (1991), and World Bank (1989).

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Conclusion

Unlike a central bank, the currency board system in the form we propose would provide the former Soviet Union with a currency that would serve as a satisfactory store of value, medium of exchange, and unit of account. In doing so, it would lay the foundation for the development of a banking system in which banks could eventually issue their own notes that competed with those issued by a currency board. Therefore, if the former Soviet Union is to make a transformation from socialism to capitalism successfully, it should utilize the currency board system. Indeed, that system should play a central role in the transformation process.

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The Benefits and Costs of Currency Boards

Allan H. Meltzer

Steve Hanke and Kurt Schuler have written another interesting paper on currency boards. I agree with most of what they say. Like them I believe that, currently, a currency board would be a better foundation for the monetary system of Russia and other former Soviet states than a central bank, commodity money, or free banking.

This is inevitably a judgment. Economic theory does not permit us to say that a currency board is always an optimal arrangement or when it would not be. No one has described the circumstances under which a currency board, or more generally a fixed exchange rate system, is optimal. Hanke and Schuler suggest that information, credibility, and the size and strength of the banking system are relevant for the choice. These are surely some of the relevant criteria.

Establishing a Currency Board

The main point on which I disagree with Hanke and Schuler concerns the method of introducing the currency board. They set up a parallel currency with full backing. The new money is distributed equally to everyone and circulates along with the existing currency at a fluctuating rate.

To me, the more appealing way is also more direct. Russia's central bank should acquire foreign exchange by selling Russian assets for foreign exchange until it has sufficient reserves to fix the exchange rate against a reserve currency, close the central bank, and offer to exchange rubles for the reserve currency on demand. These reserves would be invested in foreign securities so they earn income.

Since I agree with most of what Hanke and Schuler say, I want to take up some issues that they do not address. I will discuss, among

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others, budget problems, the inconsistency of trying to fix both nominal wages and the exchange rate, the absence of a lender of last resort, and the pro-cyclicality of money under a fixed exchange rate system. Several of these problems arise in any fixed exchange rate system, but the chief advantages of a currency board—such as heightened credibility, relative certainty about the external value of money, and elimination of discretionary action—impose costs as well as benefits under some conditions.

Budget Problems

There are two budget problems. One arises from the loss of inflation tax revenue. The social benefits of lower inflation contribute to welfare, but the loss of revenues must be offset or the budget deficit will increase. This brings us to the second budget problem—the need to close the budget deficit when the currency board is established. Government borrowing cannot be larger than the amount that can be financed from domestic saving and foreign lending. The use of saving to finance government spending will have consequences for resource use, efficiency, and future living standards. A currency board can operate if these costs are acceptable, but it cannot survive if the budget deficit is too large relative to the available nonmoney financing.

The Problem of Inconsistency

Many proposals for stabilization in Eastern Europe fix both the nominal wage rate (or nominal wage rates in the state industries) and the exchange rate. Hanke and Schuler are silent about wages, but the issue is too important to ignore.

A system with fixed nominal wage rates and fixed nominal exchange rates has been proposed in a recent study (Fischer and Gelb 1991) and adopted in Poland and other countries. This system is inconsistent. The economic system cannot in general reach a stable equilibrium at full employment with two fixed prices. Equilibrium is indeterminate. Whether prices fall, rise, or remain unchanged— and whether there is persistent unemployment—will depend on where the exchange rate and the wage rate are set. The reason is that the exchange rate determines the money stock and the price level. Therefore, employment and real wages will be determined by the fixed nominal wage and the fixed exchange rate. A currency board cannot devalue to resolve the problem.

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In general, nominal and real wages must be sufficiently flexible to maintain unemployment at a politically acceptable rate. Otherwise pressure for devaluation is likely to destroy a currency board system.

Absence of a Lender of Last Resort

A currency board does not permit the government to serve as lender of last resort. This problem arises because domestic bank deposits can be converted during a financial panic into domestic currency and then exchanged for foreign currency. Usually, currency reserves are much smaller than deposits, so this adds to the panic and the bank run. Two main solutions to this problem have been used in other contexts. The government can arrange standby borrowing facilities, as I believe principal Scottish banks did during the so-called free banking period. Or the currency board can ask the government to suspend foreign exchange payments as the Bank of England did on several occasions in the 19th century.

Shortcomings of a Fixed Exchange Rate System

A currency board has the disadvantages associated with any fixed exchange rate system. We know that fixed exchange rates are not an optimal arrangement under all circumstances or for all countries. Money growth is pro-cyclical, as under a classical gold standard. Export booms produce more rapid growth of money, raising domestic prices and encouraging imports, reductions in money, and a subsequent fall in prices. This suggests that with less than fully flexible prices of goods and services, the variability of output may be above an attainable minimum. Also, there is a risk of changes arising from inflation, disinflation, or changes in real exchange rates abroad. These problems are not unique to a currency board arrangement; they arise in any fixed exchange rate system.

No one can establish that any fixed exchange rate system, including a currency board, is optimal for Russia or other former socialist states. Further, not enough is known about the dynamics of the disinflation process to predict the costs of a permanent disinflation or the length of time required to make the benefits of disinflation larger and more apparent to the public than the costs.

A currency board would lower the costs of achieving credible disinflation, particularly if the government adopts a fiscal program that reduces the deficit to near zero. This allows domestic saving and foreign borrowing to be used for investment and economic development—including productive government investment in infrastructure.

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Limiting the currency issue to the amount consistent with foreign exchange purchases and sales restricts the government's ability to finance future deficits. This is a step toward a time-consistent policy.

Conclusion

Unlike dollarization, a currency board retains the seigniorage and the value of lost or destroyed currency for the home country and satisfies nationalistic desires for a home country currency. As in any credible fixed exchange rate system, the currency board provides the public good of enhanced stability of the internal and external value of money. By allowing a parallel foreign currency (the dollar) to be used domestically, the government can augment the credibility of the currency board. The advantages of a currency board are purchased at the costs associated with any fixed exchange rate regime. For Russia, these costs seem to me much lower than the benefits from credible disinflation and a strong commitment to stability of internal and external money values.

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Eurodollars: A Transition Currency

A. James Meigs

The Problem

What can the people and firms in the former Soviet republics and the newly independent Eastern European republics, each with its own untested national currency and poorly developed banking system, use for money in trading with each other and with the rest of the world?

When the Soviet Republics were parts of one large country, exchanges of goods and services among them were directed from Moscow and were paid for with rubles and with barter trading. All of the republics had a large fraction of their economic activity dedicated to inter-republic trade, partly because Soviet plants were geographically specialized (Peck and Richardson 1991, p. 20). Much of the trade of Eastern Europe was also oriented toward Moscow in the Council for Mutual Economic Assistance (COMECON or CMEA).[1]

Under the old regime, production was organized so that a tractor factory near Moscow, for example, had to depend for wheels upon a single source in Ukraine. Now that Russia and Ukraine are separate countries, buying wheels for the tractors has become an international trade transaction. If the Ukrainian factory managers are unwilling to accept Russian rubles or Russian goods in exchange for the wheels, tractor production in the Russian plant will be stalled until the

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[1]According to Stanley Fischer and Alan Gelb (1991, p. 97), "At the start of the reform process, about half the exports of the Eastern European nations went to countries in the COMECON or CMEA system, with the smaller countries mostly exporting manufactured goods and importing energy and raw materials from the USSR."

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managers find another wheel factory that will accept rubles or trade goods. Meanwhile, tractors sit outside the plant without wheels. In 1991, a piano factory in Czechoslovakia stacked up pianos all over the plant, hoping old customers in the Soviet Union would find ways to pay for pianos.[2]

Much of the trade within COMECON was an inferior use of resources, if it had been valued at world prices and costs. Nevertheless, these countries must continue to exchange goods and services with one another for their mutual benefit. The terms and volumes of this trade remain to be determined by competition in world markets. Perhaps even more importantly, Eastern Europe and the ex-Soviet republics must open trade with the rest of the world as rapidly as possible.

In writing about the Soviet economy before its 1991 disintegration, Richard Cooper (1991, p. 116) stated, "The opening of the Soviet economy should be an integral part of the domestic economic reforms from the outset and not delayed until many of the other reforms have become effective." He emphasized that foreign competition would strongly reinforce other measures for establishing effective competition; a flexible, innovative economy requires competitive markets to transmit information on changing demands and technological developments through price signals. He also noted that opening the economy through early introduction of currency convertibility would encourage alignment of Soviet prices with world prices from the beginning. Finally, he pointed out that opening the economy to imports would provide goods for workers whose incentive to work is adversely affected by shortages and would increase the quality and quantity of inputs available to Soviet enterprises.

All of Cooper's points on the importance of opening markets clearly apply to Eastern Europe as well as to the ex-Soviet republics. An early opening of their economies to one another and to the rest of the world is essential to progress on all other aspects of their transition from centrally planned economies to market economies. But what will they use for trading currencies?

[2]The tractor factory story is from an anecdote told by Marshall Goldman at a Harvard Club of Princeton dinner (8 November 1990). Ukrainian managers had already balked at being paid in rubles for wheels, although Ukraine was still part of the USSR. I don't know whether or not tractors are still sitting outside the plant without wheels, but I doubt that Ukrainian managers would be any happier today to be paid in rubles. I heard the piano factory story in Prague in November 1991, from an American businessman who had just visited a piano factory. Upright pianos, formerly a standard item for sale in the USSR, were stacked wherever there was any vacant space. The managers had chosen to continue producing upright pianos, until they ran out of storage space, rather than shut down the line. They had plenty of orders for fine grand pianos from Western European customers.

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Before the Soviet Union dissolved, the ruble was rapidly depreciating in purchasing power, was subject to brutal so-called currency reforms, and was barely convertible even into domestic goods. Ruble prices were very poor guides for allocating resources. The ruble's market standing under new management has yet to be refurbished. The currencies of the other newly independent republics and the banking systems supporting them are in various stages of development and have been little tested in international trade.

To reestablish trade relations within the former Soviet Union and COMECON, and to develop new trade with the rest of the world, the newly independent republics need an international trading currency, and they need it now.

The Solution

My proposed solution to the currency problem is to use Eurodollars (or another Eurocurrency) for international transactions, with free trade, free capital movements, independent currencies, full currency convertibility, and market-determined exchange rates.

This solution does not have to be applied by all of the countries at the same time. It is instead a prescription for one country, or a few countries, to follow while the ultimate monetary arrangements for the group evolve. It would allow the people and firms of the republics to choose among competing monies: national currencies—largely for domestic use—and dollars—for trade and capital movements among republics and with the outside world. The use of Eurodollars would provide valuable information on world prices and interest rates to entrepreneurs and consumers for guiding resource allocation, not only for internationally traded goods, but throughout the economy of each republic.

Why Eurodollars and not just dollars? A Eurodollar is a dollar deposited in a bank outside the United States. In the foreign exchange markets, differences between Eurodollars and dollars in U.S. banks are not important. A dollar is a dollar is a dollar in foreign exchange trading. But for international trade transactions and for international investment transactions, Eurodollars offer some transaction-cost advantages. They are not so heavily burdened with the reserve requirements, deposit insurance premiums, capital requirements, prohibitions on certain classes of transactions, SEC registration requirements, and other regulations that handicap U.S. financial institutions in international competition. Consequently, Eurodollar markets operate with narrower interest-rate spreads in many dollar transactions than U.S. banks can afford to offer at home. The Eurocurrency markets are intensely

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competitive, with thousands of traders continually searching worldwide for the lowest-cost solutions for financial problems. That should be good for potential users in the ex-Soviet republics and Eastern Europe.

Much of what will be said here about Eurodollars could be said also about Deutsche marks. For many reasons, propinquity for one, people in the newly independent republics might prefer to use marks instead of dollars for international trade and investment transactions—or to use marks along with dollars. That would not contradict the argument of this paper. The key conclusion of this paper is that the newly independent republics do not have to rely solely on their own currencies or on their own banking systems in order to trade with one another or with the rest of the world. The rest of this paper will discuss use of Eurodollars, with the understanding that Deutsche marks or some other currency might replace dollars if that is what people in the market prefer.

Solutions to many of the monetary problems of the former Soviet Union and Eastern Europe that Western advisers agonize over are right under their noses in the Eurocurrency markets. These advisers may overlook the advantages of Eurocurrencies and Eurocurrency markets for the newly independent republics because they are accustomed to relying on governments and international agencies to manage the monetary machinery for international trade and capital transactions.

The Eurocurrency markets have long escaped efforts of governments to manage them. The Eurodollar market developed in the 1950s largely as a way for Soviet bloc countries to keep their dollar balances safe from being blocked or seized by the U.S. government (Yeager 1976, p. 431). It ballooned in the 1960s as U.S. banks and corporations struggled to avoid U.S. interest-rate controls and capital controls. To a considerable degree, the Eurocurrency markets still operate outside of the governmentally installed and managed systems that preoccupy many academic and government experts on international monetary arrangements. The Eurocurrency markets are thus likely to be viewed as problems rather than as resources by some policymakers and their advisers.

Just how powerful and how versatile these market resources have become in recent years may not be fully recognized even by people who are deeply immersed in their daily operations. The Eurodollar market, and its offshoots, such as the Eurobond market and the Asian dollar market, have undergone a forced-draft evolution since the 1960s in order to cope with inflationary and recessionary shocks (Meigs 1990). Their evolution, like that of world financial markets in

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general, has gone in four major directions: (1) the time required to react to new information about economic policies and prospects has shortened; (2) new instruments and facilities for hedging against what cannot be forecast or quickly unwound have appeared; (3) securitization of lending and borrowing has increased; and (4) global market interrelationships that cushion shocks and distribute risks more widely have developed. In trying to solve their financial problems, Eastern Europe and the ex-Soviet republics should take note of these important changes.

The arguments of this paper should be viewed more as predictions than as recommendations. Although some expert advisers may overlook the potential usefulness of the Eurocurrency markets, I believe people who have their own fortunes at stake—the emerging capitalists and business managers of Eastern Europe and the ex-Soviet republics—will enter these markets to help them break out into the broader world.

Why Not Hire a Banking System?

It is widely recognized that Soviet-style banking systems require drastic restructuring if they are to serve the needs of consumers and firms in a market system (Brainard 1991). For years banks were used largely to monitor state enterprises' compliance with central plans. In the Soviet Union and Eastern Europe, banks passively loaned to money-losing state enterprises and acted as liquidity generators or engines of inflation for central governments. In short, banks really were not financial intermediaries in the Western sense.

Western advisers are generally pessimistic about the prospects for reforming and liberalizing the banking systems of Eastern Europe. Ronald McKinnon (1991, p. 121), for example, writes, "In the optimum order of liberalization, . . . the development of ordinary commercial banking may well have to be deferred for some years after liberalization begins, and to wait until overall monetary and fiscal control is secured." Stanley Fischer and Alan Gelb (1991, p. 98) write, "Even more so than other sectors, financial markets depend on underlying legal and informational systems and skills that barely exist at the start of reform." The time chart for the phasing-in of reform for finance and banking shows a four-year period of "preparation" followed by another two years of liberalization (p. 102).

The obstacles to developing efficient banking systems for Eastern Europe and the former Soviet republics that Brainard, McKinnon, Fischer and Gelb, and others identify are indeed formidable. However, the transition to market economies need not wait for each republic to build its own Western-style banking system. Banks in the

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Eurocurrency markets will be able to provide a large part of the banking services that the people and the businesses of the republics need, while the banks of Eastern Europe and the ex-Soviet republics learn their new roles. Eurobanks can mobilize deposits, extend credit, transfer funds, buy and sell foreign exchange, provide market information, trade in the securities of ex-Soviet and Eastern European firms, underwrite new issues for them, aid in risk management, and help to teach their ex-Soviet and Eastern European bank correspondents how to run banks. The governments of the republics should welcome the Eurobanks' assistance in accelerating their transition to market economies.

Eurobanks should not be expected to lend with enthusiasm to governments of the republics, or to government-owned enterprises, while an estimated $65–70 billion in debts of the former Soviet Union remain to be settled. But these debts were incurred by governments. Governments in many parts of the world have proved to be notoriously poor credit risks. However, new loans to privately owned enterprises, in countries that protect property rights, will be much more attractive business for Western banks. Credit risks may be higher for a time than on loans in these banks' home countries, but returns and opportunities for asset growth should be commensurately higher also.

Using Eurodollars, without exchange controls, would greatly speed up the clearing of international trade and capital transactions. That would be extremely beneficial to people and firms who cannot afford to wait weeks for transactions to clear, as many must do now. Efficient machinery for settling and financing international trade and investment transactions is already in place in the Eurocurrency markets.

Most world trade and international investment transactions are settled in dollars (Campbell 1990, p. 2–28). Although other currencies, such as the mark, account for a growing share of international transactions, the dollar is still preeminent. No other country can yet match the size, depth, and resiliency of the U.S. economy and U.S. financial markets on which the dollar is based. The dollar is always convertible into a wide range of U.S. goods and services and financial assets. It is welcome everywhere.

Many of these international transactions come into focus in the Clearing House Interbank Payments System (CHIPS) in New York, which processes payments messages with a daily average value of about $1 trillion. Most of the transactions processed by CHIPs are related to the settlement of foreign exchange transactions and international trade and investment activity (U.S. Treasury 1991, p. III–32). With CHIPS and with all the banks and other institutions

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of the Eurocurrency markets available to them, the republics and their banks do not have to erect much new machinery for international transactions. They merely need to get out of the way so their people can use the international payments machinery that already exists, as most other people in the world do when they have international transactions to execute.

Turning to the Eurodollar Market Would Speed Reform

One of the major advantages of using Eurodollars for settling international trade and investment transactions is that it could begin as soon as one or more countries are ready to try it. The republics cannot all be expected to move together to a new monetary system. Not one is ready now to join a new area-wide payments system, such as the European Monetary Union (EMU). Some of them may never be ready.

In the interim, countries such as Poland or Ukraine could allow their people and firms to conduct their external trade in Eurodollars. Their governments would not have to set up exchange controls, or operate exchange stabilization funds, or to borrow from the IMF, or even to hold foreign exchange reserves, if they would allow full convertibility and would allow the markets to determine the exchange rates between their currencies and the dollar or Deutsche mark.

A country would not have to yield any of its national sovereignty over its domestic currency. Nor would it have to peg its currency to the dollar or to any other currency, unless it chooses to do so. Free trade and decentralized monetary management would provide maximum scope for policy innovation and experimentation in individual countries.

Evolution of the new trading and payments system would be market-driven. Traders, for example, could initiate transactions with their customers or suppliers to be settled in dollars and could arrange to hold or obtain dollars in banks in their own countries or any other country. Entrepreneurs will have powerful incentives for finding these solutions, if they are free to do so. They have more detailed knowledge of their domestic and international markets than any government could have.

The Eurocurrency markets would provide an automatic, nonpolitical system for grading the republics on their performance in monetary and fiscal policies and on other transition policies that would influence risks and returns. Another of the advantages of the Eurocurrency markets, therefore, is that they would be open to the people and firms of poorly governed republics as well as to the

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well-governed—at varying prices. Hundreds of experts in appraising country risks would judge the paper offered them by entrepreneurs and firms of Eastern Europe and the former Soviet republics. People in the well-governed republics accordingly would pay less for credit and other Eurocurrency market services than would people in republics that were slow to master transition problems. That should provide compelling incentives for governments to do whatever would improve access to the Eurocurrency markets for their entrepreneurs and firms. Furthermore, the Eurocurrency markets would supply governments of the republics with market checks on the judgment of IMF officials and other international civil servants who might have set conditionality tests for them.

Entrepreneurs Will Lead If They Are Given Their Freedom

The proposal to rely on Eurodollars or marks for international transactions assumes that the republics will depend heavily on entrepreneurs to supply growth in output and employment by starting new businesses. Many of the large state-owned enterprises are stranded whales that may not survive in their current form even if privatized. As Fischer and Gelb (1991, p. 92) point out, many were built along Soviet lines. They were organized as large monopolistic firms, in order to facilitate central control. Their international trade was shaped by state agreements rather than by market considerations. But they now employ skilled managers, engineers, and workers who have never had enough freedom to use their talents fully. Many of these people could become entrepreneurs or go to work for new businesses. They own a large stock of underemployed human capital that is ready to be upgraded.

The new businesses should be seen from the beginning as operating in wider markets than any one nation. They must buy resources wherever they can find them and sell wherever they can find buyers. Why not let them make their own arrangements on prices and exchange rates without restrictions? For example, a manufacturer could sell his products for dollars or marks in a neighboring or distant country, basing negotiations on what he can find out about world dollar prices for similar products and for the resources needed to produce them.

Given unrestricted access to Eurodollars or Euromarks, the managers of an exporting firm would not have to worry about the many exchange rates between their country's currency and the currencies of their customers' countries. Nor would the firm have to tie up capital by holding balances in these other currencies. The firm would use

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dollars as a vehicle currency instead (see Swoboda 1968). Getting the dollars to pay the exporter would be the customers' problem. No dollars, no deals. Getting their local currency for the dollars would be the exporters' problem—if and when they want to convert. They might use the dollars to buy their materials and equipment from outside. A free market in the local currency then could tell the managers whether they had been using the right production costs in their planning, or producing the right products, or buying their inputs in the right markets to be efficient in the world market.

Entrepreneurs would discover the dollar or mark exchange rates that clear the markets, instead of having to use exchange rates imposed on them by governments. Governments will have more than enough to do trying to maintain stability in the domestic purchasing power of their currencies without trying to manage exchange rates too.

Market-determined exchange rates would insulate individual countries from much of the harm done by monetary policy errors in other countries. Individual countries would have an incentive to strive for stable-value currencies in order to maximize benefits from international trade and investment.

Some Alternatives

Many Western academic economists, politicians, and international civil servants would prefer to see the republics of Eastern Europe and the former Soviet Union adopt some variant of the Bretton Woods System, the EMU, or a common currency (Bergsten and Williamson 1990, McKinnon 1991, Shelton 1991). Some of the people giving this advice have been employed for most of their careers in trying to improve elaborate monetary superstructures in the West. It is natural for them to carry this intellectual capital with them when they go East, but applying their advice would require time-consuming, arduous negotiations among the republics. Macroeconomic policies would have to be coordinated, exchange rates would have to be adjusted and supervised, and some form of centralized authority would have to be sanctioned.

These grand solutions are not feasible near-term alternatives for Eurodollars in international transactions, given the difficulty of achieving agreement among new governments that have widely differing political foundations, poor understanding of international markets, and low confidence in one another's willingness to abide by agreements. Who would soon trust officials in Moscow, or Kiev, or Minsk, or some other power center, to run a sound monetary policy to which all of the member republics must conform? Mistakes at the center would have painful consequences over the whole area included

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in the monetary union, as did mistakes made in Moscow before 1991. Leaders of the republics have abundant reasons for distrusting central authorities.

Constructing a monetary union and/or a common currency, with or without the Soviet republics, would take far too long to be of much use in opening international trade and investment. The governments and central banks of Western Europe, despite their long experience and their armies of skilled monetary technicians and negotiators, have not yet been able to agree fully on an acceptable common currency after years of trying.

Another proposal popular in the West is to peg each republic's currency to one strong foreign currency, such as the dollar or the mark, through use of a currency board or through a central bank (Hanke and Schuler 1991, Hetzel 1990, Jordan 1991, Meltzer 1991). Pegging a currency to the dollar or the mark would mean, in effect, that dollars or marks would be used for international trade and investment transactions. That would indeed solve the problem of finding a currency for international transactions. Furthermore, it should not interfere with use of the Eurocurrency markets.

Pegging to a strong currency would provide world price information for guiding resource allocation decisions within each country and would automatically force domestic wages and prices toward alignment with world wages and prices. It might provide more nearly stable exchange rates for international trade and capital movements than would a system of freely floating rates.

Its chief advantage is that it would give credibility to a government's desire to maintain domestic price stability, by taking monetary policy decisions out of the government's hands and putting them into the hands of a more respectable government. That is the major argument for current arrangements in the EMU, in which the currencies of member countries are essentially pegged to the mark.

Although the contribution to credibility of domestic monetary policy would be desirable, pegging to another currency at the wrong exchange rate could be too great a shock in some countries. It might require too sharp a deceleration in domestic money growth. There are real costs in a sudden deceleration of money growth, as U.S. experience has shown. The Chileans found this out too, when they pegged to the dollar (Friedman 1992, pp. 234–44). Or it could lead to domestic inflation, as it did when the United Kingdom entered the European Monetary System (Walters 1991). The past history of prices in the republics would provide poor guidance in setting the initial official exchange rates. A country that already has a low inflation rate might peg to the dollar or the mark with small domestic adjustment

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costs. But countries with high inflation rates could find the transition to a pegged system more costly in output losses and unemployment than would be politically acceptable.

Furthermore, most of the successful recent experiments with pegging a national currency to a strong currency such as the dollar have been conducted in small countries—Hong Kong or Singapore, for example—in which foreign trade is overwhelmingly important. Russia and Ukraine, however, are not small countries. They are large, proud countries in which foreign trade is important but not dominant. Operating a pegged system could lead to the exchange controls and trade interventions that these countries are trying to escape. Whether Westerners approve or not, the newly independent republics are unlikely to cede control over their domestic currencies to outsiders in the near future.

When and How to Establish Currency Convertibility

How soon and how much entrepreneurs and firms in the newly independent republics can benefit from employing Eurodollars or marks will depend crucially upon when and how the currencies of their countries become convertible. Although most Western experts agree that early convertibility of some sort is essential for the republics' transition programs, many of them advise limiting convertibility to transactions on current account (merchandise trade and service-related transactions) at first. Not until later, after domestic financial markets have matured and various fiscal and monetary stabilization objectives have been achieved, should convertibility on capital account (international investment transactions) be permitted (see Bergsten and Williamson 1990; Cooper 1990, 1991; Feige 1991; Frenkel 1990; Harberger 1990; and McKinnon 1991). Holders of this general view are afraid that if the people of the republics were permitted to invest abroad or to hold money in banks abroad, the savings of their countries would flow out.

Bergsten and Williamson (1990, p. 38) expressed a conventional view when they said, "Unrestricted convertibility enables capital to flee from where it is needed, which is at home in the period of economic reconstruction that lies ahead." Ronald McKinnon (1991, p. 122) suggested another reason for limiting convertibility on capital account when he said that if newly liberalized enterprises in the Soviet Union "could freely borrow (or deposit) abroad," domestic credit restraints would be undermined. I believe that limiting convertibility on capital account for either of these reasons would be like restricting the flow of air to divers in order to save on fuel costs for the air compressors.

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In his advice on opening the Soviet economy, Richard Cooper (1991, pp. 118–19) wrote: "Soviet enterprises and households should have free access to foreign exchange for purchase of foreign goods and services, but not for the purpose of buying assets abroad or holding foreign currency." A system of monitoring would be required to ensure that foreign currency would be used for permitted purposes. In practice, this might require a limit on the amount of foreign exchange citizens could acquire for foreign travel. But Cooper made a major concession when he said, "It will be necessary, however, to have some procedure for Soviet enterprises to invest abroad in distribution and servicing channels for the sake of promoting exports. In today's world some foreign investment is often required for effective marketing of national products" (p. 119).

If we recognize money as a capital asset in a portfolio of assets, dollars or other foreign currencies held by people and firms of the ex-Soviet republics and Eastern Europe can be seen as crucial investments for the sake of promoting exports (and imports). The currencies of the ex-Soviet republics and Eastern Europe are not yet widely acceptable for international transactions inside or outside the former Soviet bloc. Other currencies, including the Eurodollar or the mark, are clearly superior as trading currencies at this time. Exporters and importers, wherever they are, must invest in a stock of one or more of these currencies in order to conduct trade and investment transactions. Therefore, limiting the opportunities of ex-Soviet and Eastern European people and firms for acquiring dollars, by enforcing capital controls, in effect would limit their opportunities for exporting and importing goods and services and for attracting capital investment. That would be like limiting their air supply.

Limiting convertibility to certain classes of transactions is an outdated mercantilist approach that has succeeded mainly in building intrusive bureaucracies that obstruct trade and capital flows. Exchange controls require bureaucrats to examine transactions to determine whether or not they comply with the regulations, thus slowing the flow of payments. They also induce transactors to use time and resources to circumvent the controls. Business managers who earn dollars or marks by selling glassware or auto parts in another country are unlikely to bring all of the proceeds back into their country if they have to turn part or all of them over to the government and then have to get into line to buy them back the next time they need foreign exchange.

It is doubtful whether Western advisers have adequately weighed the expected benefits of attempting to limit capital flights through abridging property rights with exchange controls against the expected

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benefits of protecting property rights across the board. This calculus is especially doubtful when one considers that even advocates of exchange controls on capital transactions must realize that they leak (McKinnon 1991, Frenkel 1990, and Harberger 1990). Yeager (1976, pp. 138–57), who is obviously not an advocate, presents a devastating compendium of methods used in various countries for avoiding capital controls. One of the few Western advisers to recommend early convertibility on capital transactions is Alan Walters (1991, p. 131), who says, "I would argue also for capital convertibility in order to bolster confidence in the newly free currency."

A policy of restricting convertibility for capital transactions would undermine efforts to establish the secure private property rights that are crucial for success in the transition to market economies. For example, if a firm were to receive a carload of toys from another country in exchange for a shipment of textiles, there would be no question about who owns the toys or what the firm could do with them. But if the firm were to be paid dollars, or other foreign currencies, many Western advisers assume that all or part of the foreign currencies should be turned over to the government. Property in the form of foreign exchange would not receive the protections accorded to toys. Alan Walters (1991, p. 12) says in rebuttal:

> Another way of looking at the issue is to say that restricted capital convertibility ensures that it is still possible for the government to draw a ring fence around its subjects and expropriate them at will. . . . I would suggest that capital convertibility, whether with pegged or free exchange rates, as such is a useful restraint on the power of governments to rob their subjects.

When one considers the importance of secure property rights for motivating people to work, save, and invest, a case could be made for allowing the people of the newly independent republics to hold their financial assets wherever they are satisfied with the risks and returns, whether in their own countries or elsewhere. The new capital they would generate by working harder and more productively, and the capital they could attract into their countries from outside, would far exceed the small stock of savings they have been able to accumulate working under their former rulers. It would be far more beneficial for the republics to encourage people to employ their human capital fully than it would be to impound their financial savings.

Foreign investors who want to bring capital in or nationals who want to bring their flight capital back would be encouraged if they believed there would be no restrictions on their freedom to take profits out, or to withdraw capital from losing propositions. Exchange controls have seldom, if ever, worked as advertised to prevent capital

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flights where people have had an incentive to send their capital abroad. The way to prevent capital flights is to apply domestic policies that protect property rights, encourage investment, and maintain stable purchasing power in domestic currencies. Latin American countries that are taking steps along these lines find flight capital returning.

Getting Dollars to Trade[3]

Where will the people and firms of Eastern Europe and the former Soviet republics get dollars to trade?

First, there already is a substantial stock of dollars hidden away in Eastern Europe whose owners have been hesitant to bring them to light. The unusual outflows of currency from Federal Reserve banks in recent years suggest that some U.S. residents have shipped bales of dollars to friends and relatives in their ancestral homelands. Furthermore, the Institute of International Finance has estimated that Soviet state-owned exporters kept about $14 billion of export earnings abroad in 1991, instead of remitting them to the central government in Moscow (*Wall Street Journal* 1992). There may be other such hoards to be retrieved, for some ex-Soviet officials have been in the Eurodollar markets since the 1950s (Yeager 1976, p. 434).

Second, the people and firms of these countries will have assets that they can exchange for dollars or marks after state-owned businesses and other property are privatized. They also should be able to use some of these assets as collateral for borrowing dollars or marks. This underscores the need for privatizing state property as rapidly as possible in order to supply everyone with a stock of negotiable assets.

Third, entrepreneurs will create new assets in the form of goods and services that they can sell in export markets for dollars. Financing these exports with dollars should be attractive business for American, European, and Japanese banks. Short-term trade finance is bread-and-butter business for banks.

Fourth, banks and investors in other countries will supply dollars for investments in these countries, once they are assured that property rights are secure and that there will be no restrictions on their ability to draw out earnings and principal. North American investors in particular probably will view some of the republics as turnaround opportunities, as some now view investment opportunities in Latin America.

[3]This section draws on suggestions made by Robert Hetzel and Charles Plosser (see Plosser 1991).

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Conclusion

The newly independent republics of the former Soviet Union and Eastern Europe desperately need broadly acceptable, convertible currencies for settling international trade and investment transactions, both within the old Soviet Bloc and with the rest of the world. Their national currencies and their developing banking systems lack the necessary acceptability and experience to serve them well in international trade and investment transactions. Yet opening international trade is crucial to the success of all of their other transition policies.

Many Western advisers on transition policies recommend that the republics build multilateral currency arrangements similar to the European Monetary Union or a common currency for several or all of the republics. Other Western advisers recommend that the republics peg their currencies to a strong Western currency such as the dollar or the mark through a currency board or a central bank. Both of these measures would provide them with dollars or marks for settling international transactions. Although such institutions may ultimately evolve, the republics do not have time to wait for them before finding a way to enter world markets.

The people and firms of the republics are more likely to find an interim solution to their need for international trading and investing currencies in the Eurocurrency markets. The Eurocurrency markets can supply dollars or Deutsche marks for settling international trade and investment transactions. They can supply rapid, efficient clearing of transactions. They also can supply financing for many transactions.

To expedite their transition to market economies by using Eurodollars, the governments of the republics would not have to create any new institutions. They merely would have to get out of the way and allow entrepreneurs of their countries to make their own arrangements. They would realize maximum benefits from use of the Eurocurrency markets if they would make their currencies fully convertible, avoid all exchange controls, permit free trade and capital investment, protect property rights, maintain stable domestic purchasing power for their currencies, and let their exchange rates be determined in free markets.

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Monetary Institutions during the Transition to a Market Economy

William A. Niskanen

Money in Transition

There has been a great deal of intelligent discussion about the effects of alternative monetary institutions for the new governments of Central and Eastern Europe. Most of that discussion, whether recognized or not, addresses the issues that bear on the choice of monetary institutions for the long run. The paper by Jim Meigs, however, addresses a more urgent task, namely, the choice of monetary institutions during the *transition* to a market economy.

Leaders in ex-communist countries (ECCs) do not have the luxury of an extended academic debate on the issues that bear on the choice among alternative monetary institutions. They must get on with their job under conditions that most of us would regard as chaotic. What should the officials of these new governments do? Meigs gives an answer that should resonate with market liberals: Get out of the way! Specifically, Meigs recommends that the governments of these countries allow their individuals and firms to conduct *international* transactions in the markets for both goods and capital in some Euro-currency—immediately and without exchange controls.

One should not wait, he recommends, for the development of a stable domestic currency, which will take time and will depend critically on establishing a fiscal policy that is not dependent on central bank financing. For international transactions, any person or firm can immediately "borrow" the monetary policy of the Federal Reserve or the Bundesbank.

One should also not wait for the development of a domestic banking system. Again, for international transactions, any person or

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firm can "borrow" the developed banking institutions of the West.

Abolish Exchange Controls

Meigs also argues, I believe correctly, against any exchange controls on the flow of capital. There is reason to be concerned about capital flight, about "our" saving being used for investment abroad when it should be invested at home. In response, Meigs makes three arguments:

1. Exchange controls raise the cost of moving capital across national borders but are not very effective in limiting capital flight when domestic conditions substantially reduce the security of property rights.
2. Foreign private investment in ECCs is important to promote export sales.
3. Most important, exchange controls discourage foreign investment in the home country, by restricting the repatriation of earnings and the liquidity of the investment.

For these reasons, the termination of exchange controls usually leads to an increase in capital flows in both directions and often to a net inflow to the nation ending these controls.

Benefits of the Meigs Approach

In summary, I suggest, the Meigs approach is the best approach to financing international transactions in the transition period. This approach does not resolve the choice among alternative long-term monetary institutions, but it avoids the different down-side risks of a premature commitment to a specific long-term alternative. One attractive side-effect of this approach is that it would permit the finance ministers of the new countries to tell the boys from the IMF to go home, or go to hell, whichever is closer. I can hardly wait.

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Sound Money and a Liberal Market Order

Malcolm S. Forbes, Jr.

Though circumstances and times change, the basic principles of economic progress and sound market order do not. There is no mystery about them. They involve sound money, low taxes, property rights, making it easy for businesses to be set up, and, once they are, not harassing them with excessive regulation and bureaucratic interference. And, of course, free trade. They sound very simple, but, unfortunately, when you see the policies—or lack of them—that we seem to be pursuing, even these simple principles seem to go by the boards.

The thing a country needs first is real, sound money. You cannot have a truly functioning economy without real money. But that fact seems to be lost on many Western policymakers. Having no money is like having a body without blood. It ain't gonna function.

Without a sound currency, other reforms necessary for a vibrant, free economy either are not going to be possible or are going to take a long time coming into effect.

International Handouts No Answer

What the struggling countries of the former Soviet Union do not need are gobs of Western foreign aid. That would only subsidize self-perpetuating bureaucracies and destructive policies. What they do need are open markets and free trade. Free trade and private investment—domestic or international—will do far more than foreign aid.

They also do not need more mindless austerity. Some Western agencies seem to suggest that the poorer you get, the better off you will be, because that builds character.

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The author is President and Chief Executive Officer of Forbes, Inc., and Editor-in-Chief of *Forbes* magazine. The paper is based on his opening address at the Cato Institute's Tenth Annual Monetary Conference, March 5, 1992.

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Statistics will show that in a true free-market transition—switching from one set of rules to another set of rules—there is a lot of depression and unemployment, but that is only a transition period between one environment and a new, freer one. The transition should be relatively short and should not be a painful one, as Japan, Italy, and other countries proved after World War II.

The idea that we have to wait a couple of generations before countries can truly get on their feet is absolute nonsense. You do not make an economy healthy by making the people within it poor. There is considerable entrepreneurial energy in the former Soviet Union and in Central and Eastern Europe. That is how those people survived 70 years—by having the wits and energy to get around the obstacles that were placed in their way.

Unfortunately, strategists, diplomats, and geopolitical realists all seem to overlook the best long-term defense. They all think in military terms, but the best long-term defense is one of encouraging democracy and economic liberty. True democracies don't go to war with each other. But democracy won't sink deep roots in the former Soviet Union and much of Central Europe unless the principles I have mentioned are put to work. If there is perpetual depression, if there is perpetual economic turmoil, democracy simply won't work.

In countries such as Poland and Russia, what leaders call shock-treatment free-market economics is too often a cloak for madness. You find it is anything but free-market economics when you examine it in detail. It makes the situation worse, not better.

Which Way Will the Winds Blow?

Today the United States and the West are in a state of flux. The question asked is: Will the U.S. pursue the spirit of isolationism of the 1920s and 1930s or the more imaginative approach of the post–World War II period? We speak the rhetoric of the late 1940s, but our policies are too reminiscent of the 1920s. We turned our backs on the rest of the world. We enacted an anti-immigration law in 1924, and then at the end of the decade, with Smoot-Hawley, we turned to a form of economic isolationism. And we know what happened with that.

Our policymakers seem to forget that democracy in the 1920s and 1930s withered in more than 20 countries—not from external aggression, but from internal collapse brought about by economic chaos. Among them: Poland, Hungary, Lithuania, Latvia, Estonia, Turkey, Greece, Spain, Portugal, Austria, Japan, China, Brazil, Argentina, and, ultimately, Germany. Today's idea that democracy is sort of a done deal has been shown historically to be absolutely short-sighted.

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So we did the wrong things in those days. Remarkably, American business leaders were more activist, more internationalist in the 1920s; that is how we got the Dawes Plan and the Young Plan. But the political trend was isolationist, and the world paid a severe price for it.

In the late 1940s the West's reaction was different. We instituted the General Agreement on Tariffs and Trade and the Bretton Woods international monetary system. We needed safety and security from predatory neighbors, so NATO did work in that respect. While historians and philosophers can point out a lot of flaws in these postwar institutions, most of them for most of the time did more good than harm—especially compared with what had gone on earlier.

Clearing the Way for Democracy

The most instructive, immediate step that the United States can take now to help struggling democracies is to encourage the creation of sound money. There are plenty of models around for how to do that: Germany, Japan, and Italy after World War II. Today we can look at South Korea, Mexico, Argentina, and the Czech Republic.

Polyconomics, a firm in my home state of New Jersey, has an intriguing proposal for resurrecting the dead ruble. As we sold our public lands 200 years ago to help back our bonds, Russia likewise has plenty of assets it could use to revive its currency—assets of $3 trillion to $6 trillion.

There are plenty of other sound approaches to help the Russian economy, such as the sale of its military and aerospace technologies to American firms and government agencies. Buying Russian technology would keep Russian scientists working—working on our kinds of projects rather than for the Kim Il Sungs of the world. It would also give Russia some badly needed hard currency and save us billions of dollars in development costs.

So far the United States has not really pursued these opportunities. Why? State and Defense Department apparatchiks feel that if they block the sales, they'll ruin the former Soviet military and industrial complex, and Russia will never become a great power again. The idea that if you wreck a country's industry you somehow increase your own security is preposterous.

We should be pursuing the tried-and-true models for helping these countries; it's a matter of political will. We will not get the kind of revival needed in Russia and Eastern Europe unless we do. The hope of democracy there will fail if we continue on our current course.

It is very important for all of us to remind both the private and public sectors of how destructive it is to engage in monetary manipulation, to allow unsound money. Currency manipulation is a

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form of protectionism. It is immoral in that it gives some people unearned gains and gives other people unearned, unexpected losses. In a way that I do not think historians fully grasp, currency manipulation undermines the rule of law, property rights, and people's faith in economic liberty when they see huge changes done in an arbitrary, capricious manner that has nothing to do with work, innovation, or creativity.

Sometimes we approach the subject of money as if it were the root of all evil. Well, it may sometimes encourage evil, but it is ridiculous to think that money invented the underside of human nature. In fact, money, in its own way, channels and guides human aggression, pride, ambition, and desire into fruitful and productive pursuits that ultimately benefit us all. In short, sound money makes possible free markets, and free markets in turn are the essence of human progress.

A Golden Opportunity

The 20th century began as an optimistic age, especially in this country. People felt it would be a golden age of not only material progress but also political enlightenment: more democracy, more rule of law. Then came World War I, which undermined people's faith in Western institutions and helped begin the process of undermining people's faith in progress. It made possible communism, fascism, and naziism and, of course, led to another world war.

After World War II, there were two models on the table: our model and that of the Soviet Union. With the collapse of the legitimacy of communism in 1991, you might say we are back to where we were in 1914, back again in a position to redeem the promise with which this century began. We have a chance to do it right this time.

In 1914, as the world descended into war, few people realized the magnitude of the impending disaster. One who did was Sir Edward Grey, Britain's foreign minister. He said, "The lamps are going out all over Europe; we shall not see them lit again in our lifetime." If the United States pursues sensible policies, in terms of getting sound money and other central parts of economic liberty in place, then those lamps will be relit—not only in Eastern Europe and Russia, but throughout the world—not only for our generation, but for generations to come.

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BOOK REVIEWS

From Marx to Mises: Post-Capitalist Society and the Challenge of Economic Calculation
David Ramsay Steele
La Salle, Ill.: Open Court Publishing Co., 1992, 424 pp.

David Ramsay Steele, a former Marxist, shares with us his odyssey through the socialist "calculation problem"—how to know the value of goods and services, or whether outputs are more valuable than inputs, in the absence of a market system. That issue greatly interested me a quarter of a century ago. After examining it, I concluded in my book, *Alienation and the Soviet Economy*, that socialism expressed a passion for conviviality and that its inordinate aspirations had been defeated by a refractory reality.

Anyone who wades through Steele's 424 pages will be convinced that belief in socialism was a pure leap of faith that jumped right over all of the theoretical and practical issues. In the scientific 20th century, governments set out to build socialism guided by nothing. The result was disastrous. As Steele puts it, "Marxism ensured that millions would perish before we could all agree that Marxian socialism was an impossibility."

When one looks back at the socialist debate and accounts of Soviet experience, one is overwhelmed by the lack of perception on the part of so many intelligent people. As recently as 1989, Lester Thurow, dean of the business school at the Massachusetts Institute of Technology, wrote of the Soviet Union, "Today it is a country whose economic achievements bear comparison with those of the United States." Thurow was convinced that Ronald Reagan's pro-market policy would fail, but socialism had been vindicated by "the remarkable performance of the Soviet Union."

Statements such as Thurow's are interesting not merely for their absurdity. Factually incorrect claims of Soviet economic prowess were generally regarded by those who made them as statements of their moral honesty. To acknowledge the success of socialism simultaneously demonstrated one's intellectual sophistication and vented one's alienation from capitalism.

But as Steele shows in his book, "all arguments against capitalism fail unless there is some feasible alternative which can do better." The

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Marxists and socialists acted out of conviction alone. Steele argues that this conviction was based on misconceptions, misinterpretations, and a general lack of depth in thinking. For example, he shows how central planning seemed inescapable to people who believed that capitalism could not last because the number of firms must become ever smaller until the whole economy became a single dominant firm. That same kind of thinking prevented socialists from realizing that it was "the anarchy of production" that solved the economic calculation problem, something that "conscious planning" was never able to do. As F. A. Hayek, the student of Ludwig von Mises, who launched the calculation debate in 1920, stressed, information is decentralized in society, and Marxist attempts to eliminate "anarchy" made economic calculation impossible.

Steele's revisit of the debate sets out the issues in it and shows how each one was avoided or fuzzed over in order to escape the conclusion that there was not even a theoretical alternative to the market for a modern society. A primitive native tribe might operate without "commodity production" (production for market), but not an industrial society. The possible combinations of inputs and outputs are simply too large to be controlled by anything but market demand.

Steele's book would have gained in interest by suggesting why so many scholars gave socialism and the Soviet economy the benefit of the doubt while they wrote theoretical articles about "The Anatomy of Market Failure." Market economies do not use more valuable inputs to produce less valuable outputs, but Soviet gross output planning did. Economists should have instantly perceived the inherent failure of the Marxist approach.

I remember from my graduate school days that when one left microeconomic topics and took up Soviet economics or comparative economic systems, the standards of evidence and argument changed dramatically. In the latter classes, emotion-based standards of truth existed. It was an intellectual arena in which truth rested upon images and feelings and not on knowledge born of experience. The attitude was that if socialism did not exist, we would have to invent it because capitalism was so awful.

The "socialist debate" was a politically correct one. Those critical of socialism in theory or practice demonstrated a moral backwardness that was unwelcome on academic faculties. The study of alternative economic systems became an inbred activity producing fantasy. Consequently, the experts were not prepared for the sudden collapse of communism.

In May 1981, President Reagan at Notre Dame University dismissed communism as "a sad, bizarre chapter in human history whose last pages are even now being written." The experts went berserk. Columbia University professor Seweryn Bialer, for example, confidently contradicted Reagan in *Foreign Affairs:* "The Soviet Union is not now nor will it be during the next decade in the throes of a true systemic crisis, for it

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boasts enormous unused reserves of political and social stability that suffice to endure the deepest difficulties."

"Openness to argument," Steele writes, "is a wonderful virtue," but it did not characterize the academic study of socialism.

Paul Craig Roberts
Cato Institute

Universal Economics: Assessing the Achievements of the Economic Approach
Gerard Radnitzky, ed.
New York: Paragon House, 1992, xii + 446 pp.

The editor opens with a 68-page essay setting forth this book's organizing thesis that economics offers a universally valid approach to all social phenomena. Gerard Radnitzky explains: "What gives economics this 'imperialist' power is the fact that its key concepts are universal in applicability .... The basic building blocks of economic theory, e.g., optimizing and equilibrium, are ... readily applicable to almost all social phenomena." In this respect, the editor remarks that this book "may be viewed as a sequel to the volume *Economic Imperialism.*"

What follows are essays on six substantive areas: biology, sociology, politics, law, history, and international relations, the point of which is to illustrate the universal validity of the economic approach to social phenomena. This book does a good job overall in making its case, even if the essays vary in the degree of support they give to its theme. Nonetheless, the claim that the economic approach provides a universally valid framework for social analysis is weakened, in my judgment, by linking that claim to economic imperialism. One can affirm the universal validity of the economic approach without embracing economic imperialism. The economic approach, which is a formal system for organizing thought about social processes and institutions, must not be confused with economics, which is a substantive inquiry into the coordination of economic activities and the nature and causes of the wealth of nations.

As a formal organizing principle, the economic approach is grounded on two fundamental presumptions, one concerning human action and one concerning human interaction. The former presumption is variously expressed by notions of rationality, maximizing, or optimizing, and in any event is formal and not substantive. It says that people seek to be effective in action, but does not inquire into the specific forms or objects of action. The latter presumption is usually expressed by some notion of equilibrium, which is an assertion that there is a rhyme and reason to all that happens under the sun. The apprehensible order in human affairs

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was stated clearly by Ecclesiastes and has nothing to do with any characterization of equilibrium as a state of rest. In any case, the twin principles that people are purposeful and resourceful in their conduct and that vigor and intensity dominate sloth and lassitude in the course of human affairs form the core of the economic approach to social life.

Economic imperialism, by contrast, is the straightforward extension of economic explanations concerning market processes and institutions to alternative subject matter. Economic imperialism claims that this extension is sufficient to supply substantive knowledge in those other areas.

Peter Ordeshook, in his survey of the development of the rational-choice approach to politics and political institutions, goes to great lengths to deny the claims of economic imperialism. He argues that substantive economic propositions concerning rationality and equilibrium do not go very far in explaining political institutions and processes. While denying the claims of economic imperialism, Ordeshook nonetheless affirms the universality of the economic approach when he argues that economics and politics are united in their being governed by the principles of rational choice and equilibrium, even if the substantive application of those formal categories must vary across particular institutions and processes.

Michael Ghiselin argues that biology and economics are united by a common grounding in scarcity and competition, and finds specific instances of reasoning based on those principles in the biological literature on evolution, physiology, sex allocation, foraging, ethology, and ecology. James Coleman contrasts the economic approach to sociology, what he calls rational-action theory, with the approach of functionalism. He argues for the greater explanatory power of the economic approach with reference to such matters as the emergence and maintenance of norms, the generation of panics, the submission to authority, and the emergence of trust.

Alan Schwartz examines the contributions of economic ideas to two bodies of law: unconscionability and damage awards for mental anguish. Schwartz's material is presented thoughtfully, though also very skimpily. In a book dedicated to showing the universal applicability of the economic approach to other substantive areas of social life, it is truly strange to see an essay on law that does not even mention the Posnerian scholarship that argues that the entire body of substantive law conforms to an economic logic. Roger Meiners argues that the economic approach provides a valuable framework for historical investigation, and surveys briefly some of the seminal works in both the cliometric and the new institutional approaches to history.

The unit on international relations contains two essays, one by Gordon Tullock and one by Peter Bernholz. Tullock actually argues that the economic approach cannot provide much insight into international relations, and invokes the claim that economics is more suited to the

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study of cooperation than conflict. This is surely a strange claim by the author of a valuable, though undeservedly neglected, book, *The Social Dilemma*, which demonstrates the value of the economic approach to international relations. Bernholz examines the ability of economic reason to illuminate international relations, arguing in the process that balance-of-power systems with several states are more stable than either bipolar systems or multipolar systems with many states.

For the most part, these essays work well as surveys of existing literature: they expose the reader to a lot of different material in the fields being surveyed, and they provide a good supply of references for those interested in further examination of particular topics. The editor is quite right to claim that economics provides a general framework for a unified social theory. This book does a good job of conveying that claim to those who are already predisposed to accept it. However, I doubt that it will prove to be a suitable homiletical instrument for taking that claim before those not so predisposed, because for the most part these essays do not engage the alternative approaches to the subjects that are examined here. But to say that, is simply to say that much work remains to be done in securing general recognition of the universality of the economic approach.

Richard E. Wagner
George Mason University

Forbidden Grounds: The Case Against Employment Discrimination Laws
Richard A. Epstein
Cambridge: Harvard University Press, 1992, 530 pp.

Discrimination law in the United States is a quagmire of legislation, judicial interpretations, and federal agency edicts that seemingly defy rational treatment. Since the passage of the Civil Rights Act of 1964, and particularly its Title VII outlawing employment discrimination, Congress has seen fit to enact additional antidiscrimination statutes to protect pregnant women, workers over the age of forty, disabled government workers, and most recently, disabled individuals in the private sector.

The judiciary's creative impulses have only added to the complexity. Courts have repeatedly approved affirmative action as a putatively short-term fix for historical discrimination, despite clear language in the 1964 Act averring that nothing therein required preferential treatment or inferences of discrimination from statistical comparisons. Judicial alchemy surmounted Title VII's requirement that intent be proven before an employer could be convicted of discrimination, by affixing to the act the concept of "disparate impact." Thus, employment practices that were

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fair in appearance could nevertheless fall afoul of Title VII if they had a "disparate impact" on protected minorities or women. The Americans with Disabilities Act of 1990, written in purposely vague language, invites ad hoc, case-by-case judicial decisionmaking, as employers are left at the mercy of test cases on what is or is not "reasonable accommodation" for a handicapped employee or job applicant. On this one act alone, consultants are enjoying a feeding frenzy as panicky employers seek some protection, however illusory, from exposure to compensatory and punitive damages for violations of standards that have yet to be elaborated.

Into this morass steps Richard Epstein, with undoubtedly his finest work to date. *Forbidden Grounds* is a truly impressive effort, and one that should be much more appealing to libertarians than *Takings: Private Property and the Power of Eminent Domain*, Epstein's previous venture into legal quicksand. While many libertarians found *Takings* frustrating for its foundational admixture of rights talk and utilitarianism, and its consequent vacillations, what is most appealing, in contrast, about *Forbidden Grounds* is its foundational consistency. The theoretical framework that Epstein erects is at once pellucid yet brilliant, and sturdy enough to navigate through the whole panoply of employment discrimination issues: from race to sex discrimination, disparate treatment to disparate impact, sexual harassment to pensions, pregnancy to affirmative action, age discrimination to disability discrimination.

Epstein constructs his edifice upon an organizing principle—freedom of contract—that generates a legal regime that is the antithesis of a regime built upon a competing antidiscrimination principle. Freedom of contract, as he defines it, "allows all persons to do business with whomever they please for good reason, bad reason, or no reason at all." Under such a regime the state's principal function is to "ensure that all persons enjoy the civil capacity to own property, to contract, to sue and be sued, and to give evidence." The state prohibits the use of force and fraud, and its reach extends barely much further. No special "status-based" rights need be created, no rules to limit the "zone of freedom" of employers, landlords, and manufacturers. Individuals are left free to engage in trade with others or not, as they alone see fit, subject only to the requirement that they meet their freely chosen contractual obligations.

Freedom of contract's antipode is the antidiscrimination principle, which breeds an interventionist and expansionist regime with which we are all too familiar: a regime of "forbidden grounds" in which the state bars private employers from considering certain properties of a person—race, sex, age, national origin, religion, handicap, and in some venues, sexual orientation—in making employment decisions. This principle is as universally accepted as it is rarely defended, Epstein observes, and thus it is ripe for scrutiny, particularly of the sort refined by the law-and-economics movement, with its concern for minimizing costs and generating

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efficient legal rules. With law and economics' weapons for the analysis of social policy in hand—transaction costs, information costs, agency costs, moral hazard costs, and political costs—Epstein undertakes a forced march through the battlefields of employment discrimination law. To prevail, he must vanquish "the entire apparatus of the anti-discrimination laws" as they apply to private employers.

Epstein's journey from the Hobbesian state of nature to Lockean self-ownership of one's labor (now given a "deeper functional justification" than Locke's natural rights) to the development of the common law on labor relations to his final call for the repeal of Title VII is intricate, inventive, and intellectually compelling. Of particular theoretical interest is a chapter on "Force, Discrimination, and Free Entry," in which he deploys the economists' concept of comparative advantage to analyze the labor market. He demonstrates that even if private discrimination exists, market pressures on the marginal employer will push him to break ranks and hire from the disfavored pool as the favored pool of potential employees gets winnowed down. The worth of each laborer is determined, he argues, by the trading partner who most values his services, and thus in a large, diverse labor marketplace, those employers with a taste for discrimination will have little effect on the disfavored, who will have many other options open to them.

Anti-discrimination laws of various sorts, especially those like the Equal Pay Act of 1963, which commands equal pay for equal work, will operate to distort those natural market forces by preventing the disfavored from offering their services at lower rates, and thus will hurt their intended beneficiaries. Another effect of anti-discrimination laws is to limit the information that employers are permitted to gather about particular employees. Ironically, then, restrictions on testing and interviewing promote the very stereotypical decisionmaking that they were intended to eliminate.

Epstein's discussion of "Rational Discrimination in Competitive Markets" will undoubtedly exasperate both the old, Hubert Humphrey-type liberals who championed the Civil Rights Act as the harbinger of a "color blind" society and the newer welfare-state liberals who have abandoned that aspiration in favor of preferential treatment and proportional representation. The former will likely find distasteful Epstein's argument that since individuals do show preferences for identification with people like themselves, homogeneity of the work force within firms (as within condominium associations) is both rational and efficient, and thus voluntary discrimination is likely to persist over time in competitive markets. The latter will recoil at his argument that a perfect match between the racial composition of the firm and the surrounding community, rather than being the hallmark of a successful anti-discrimination regime, is instead a signal that the gains from trade through specialization have not been realized, that the market is underdeveloped, and that

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government regulation has wrought dangerous effects. Both might find disturbing Epstein's willingness to accept people as he finds them, replete with whatever tastes and preferences for discrimination that they might have. But he presents an argument that cannot be lightly dismissed for "allowing persons to sort themselves voluntarily by inclination and taste."

Forbidden Grounds marshals in virtually every chapter a no-holds-barred challenge to today's orthodoxy. Recalling the often vituperative, ad hominem reviews that *Takings* received, and surmising that welfare-state liberals care more deeply about the anti-discrimination agenda than they do about eminent domain and regulatory takings, my initial hunch was that *Forbidden Grounds* would either be ignored by reviewers or garner even more scandalous reviews than its predecessor. Happily, neither seems to be the case, for the book has been reviewed widely in the legal journals and beyond, and for the most part civilly. It remains to be seen, however, whether *Forbidden Grounds* will have the impact that it deserves; whether it will be a work in legal thought like Robert Nozick's *Anarchy, State, and Utopia* in political philosophy: a work that every serious writer must take into account, if only to disparage. On its merits, it manifestly deserves such standing, for it is truly a path-breaking effort.

Ellen Frankel Paul
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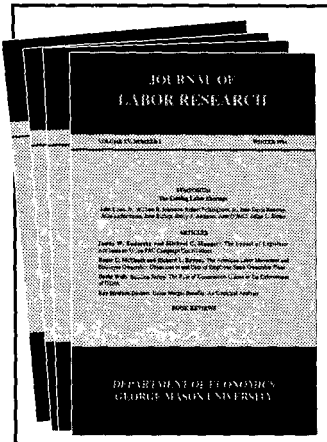

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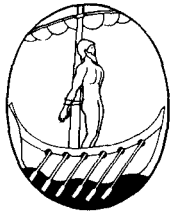

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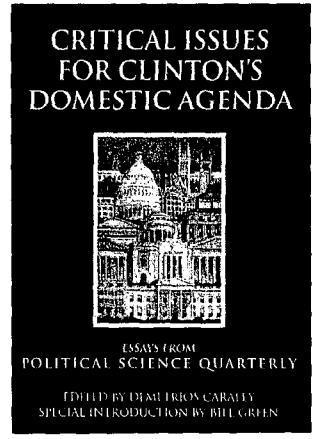

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CRITICAL REVIEW: An Interdisciplinary Journal invites papers from economists, historians, political scientists, and sociologists on aspects of the interventionist, redistributive state, including critical studies of: the need for/effectiveness of intervention during past eras (e.g., the Industrial Revolution, the Progressive Era, the Great Depression, the post-colonial era); the causes of economic or social problems, past or present; and the efficacy of bureaucratic, legislative, or electoral politics in solving such problems in the past. Historical case studies and comparative analyses of these and other topics related to the viability and rationality of state intervention in the first, second, and third worlds are encouraged, but CRITICAL REVIEW does not publish policy proposals or critiques of proposed policies.

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SOUND MONEY, THE LAW, AND FREEDOM

Inflation, the spirit which nourishes it and accepts it, is merely the monetary aspect of the general decay of law and a decline of respect for law. It requires no special astuteness to realize that the vanishing respect for private property is very intimately related to the numbing of respect for the integrity of money and its value. In fact, laxity about private property and laxity about money are very closely bound up together; in both cases what is firm, durable, earned, secured and designed for continuity gives place to what is fragile, fugitive, fleeting, unsure and ephemeral. And that is not the kind of foundation on which free society can long remain standing.

—Wilhelm Röpke

Welfare, Freedom, and Inflation
(1957); in Johannes Overbeek (ed.),
2 *Essays by Wilhelm Roepke* (Lanham, Md.:
University Press of America, 1987), p. 103.

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